

TAX INFORMATION SERIES

JA 269



ADMINISTRATIVE AND CIVIL LAW DEPARTMENT

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PREFACE

This series of tax information handouts is in camera-ready format for use in your local Tax Assistance Program. Each has a cover sheet onto which you can insert the telephone number and location of your office. You can then distribute these handouts in the Legal Assistance waiting room or at other locations on post.

The handouts are handy synopses of many federal income tax issues, and can serve as a quick desk reference for the legal assistance provider. The materials may also be used as the basis for preventive law articles in the installation newspaper or weekly bulletin.

The handouts were developed from materials provided by the IRS, various Army Legal Assistance Offices, the U.S. Air Force Preventive Law, and others.

Offices developing additional handouts that would be suitable for inclusion should submit them to: The Judge Advocate General's School, ATTN: JAGS-ADA, Charlottesville, VA 22903-1781.

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This publication is one of a series prepared and distributed by the Legal Assistance Branch of the Administrative and Civil Law Department of The Judge Advocate General's School, U.S. Army (TJAGSA). Legal assistance attorneys should find this series useful in the delivery of legal assistance. The information contained herein is as current as possible as of the date of publication. Attorneys should recall, however, the law is subject to legislative amendment and judicial interpretations that occur much more rapidly than this publication can be updated and distributed. For this reason, use this publication only as a guide and not final authority on any specific law or regulation. Where appropriate, legal assistance attorneys should consult more regularly updated references before rendering legal advice.

The series contains summaries of the law, guidance, and sample documents for handling common problems. The sample documents are guides only. Legal assistance attorneys should ensure that the samples are adapted to local circumstances and are consistent with current format provisions in Army Reg. 25-50 prior to reproduction and use.

The series is part of the continuing effort to improve and expand the resources available to legal assistance practitioners. As you use this publication, if you have any recommendations for improvement, please send your comments and suggestions to The Judge Advocate General's School, ATTN: JAGS-ADA-LA, Charlottesville, Virginia 22903-1781.

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Each year, the Legal Assistance Branch receives many requests for its publications. Because of limited budgetary and personnel resources, however, additional outside distribution of these materials in printed format may not be possible.

The Defense Technical Information Center (DTIC) makes some of these publications available to government users. Practitioners may request the necessary information and forms to become registered as a user from: Defense Technical Information Center, 8725 John J. Kingman Road, Suite 0944, Fort Belvoir, Virginia 22060-6218, telephone (703) 767-9087 or DSN 427-9087.

This publication does not promulgate Department of the Army policy and does not necessarily reflect the views of The Judge Advocate General or any government agency.

January 2002

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**2001
TAX
INFORMATION
SERIES**

**TAX UPDATE FOR
2001 RETURNS**

This pamphlet provides information concerning your federal income taxes. If you have legal questions concerning your taxes, and your unit tax advisor is unable to answer them, call the number below for an appointment to see a lawyer.

**LEGAL ASSISTANCE TELEPHONE
NUMBER**

OFFICE OF THE STAFF JUDGE ADVOCATE

Update for 2001 Federal Income Tax Returns

It was the biggest economic story of 2001. On June 2d, President Bush signed a \$1.35 trillion tax cut into law. The law, known as the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) purports to reduce the tax rates, repeal the estate tax, provide marriage penalty relief, expand education incentives, increase the child tax credit, and provide pension relief. The catch, with the majority of provisions being phased in over the next ten years (2001 through 2010), it will take eleven years to realize the full effect of the cuts. Then, to comply with budgetary restraints, the entire package of tax cuts “sunsets,” i.e., goes away, in 2011. This sunset provision essentially returns the tax laws to their pre-June 2, 2001 state.

While EGTRRA was big story of 2001, this article is not an analysis of EGTRRA. Actually, little of EGTRRA affects the individual taxpayer for tax year 2001. The purpose of this article is to provide a brief update of tax changes that are important for taxpayers in the military community. Its goal is to inform legal assistance attorneys of updates in tax numerology and changes for the upcoming tax season. Some of these changes arise from EGTRRA; some were scheduled to take effect based on existing law.

Key Changes for 2001

Resulting from EGTRRA

Tax Rates Reduced

With the exception of the 15percent tax bracket, all tax rates were reduced in 2001. The existing tax rates of 28 percent, 31 percent, 36 percent, and 39.6 percent, are reduced by one-half of one percent. The rates for 2001 are now 27.5 percent, 30.5 percent, 35.5 percent, and 39.1 percent. These rate reductions are reflected in the current tax tables. These rates will be reduced by one-half of one percent per year through the year 2006.

The Act also creates a new 10-percent regular income tax bracket for the portion of taxable income that is currently taxed at 15 percent. It is effective for taxable years beginning after December 31, 2000. The 10-percent rate bracket applies to the first \$6,000 of taxable income for single individuals (\$7,000 for 2008 and thereafter), \$10,000 of taxable income for heads of households, and \$12,000 for married couples filing joint returns (\$14,000 for 2008 and thereafter). While EGTRRA created a 10 percent income tax rate, it is not reflected in the 2001 tax tables or schedules. Rather, for 2001, the 10-percent rate is implemented as rate reduction credit. However, the benefit of the 10-percent bracket is extended to dependents. A worksheet is provided in the instruction to Form 1040 to use to for this purpose.

Rate Reduction Credit

For 2001 only, the 10-percent income tax rate bracket is implemented through a rate reduction credit of 5 percent (the difference between the 15-percent rate and the 10-percent rate) of the amount of income that would otherwise be eligible for the new 10-percent rate. The maximum credit will be \$300 in the case of a single individual, \$500 in the case of a head of household, and \$600 in the case of a married couple filing a joint return. Many taxpayers received an advance rate reduction credit in the form of a check issued by the Department of the Treasury. The advance payment of this advance is based on tax data from 2000.

For those who received either no rebate check or one for less than full amount, the rate reduction credit is taken when filing the 2001 tax return. The credit is calculated on a worksheet in the instructions to the Forms 1040, 1040A, and 1040EZ. Calculating the credit requires the taxpayer to take into account, any advance rebate check received. If the taxpayer received a rebate check, the amount of the advanced payment reduces the potential credit. If the advance payment is equal to the maximum credits, the taxpayer will not be able to claim the credit. If the advance payment received is less than the full credit the taxpayer may qualify for the credit. That taxpayer will calculate the amount to which he is entitled, offset that amount by the advanced payment, and claim the excess. If the advance payment exceeds the credit to which the taxpayer is entitled, he need not return the excess advance payment, nor include any excess in income.

Larger Child Tax Credit

Taxpayers with a qualifying child may take a child tax credit. EGTRRA gradually increases the child tax credit per child to \$1,000, over ten years. For calendar years 2001-2004, the credit is \$600. The child tax credit is made refundable (whether or not the taxpayer pays any federal income tax) to the extent of 10 percent of the taxpayer's earned income in excess of \$10,000 for calendar years 2001-2004. Families with three or more children are allowed a refundable credit for the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit (the existing-law rule), if that amount is greater than the refundable credit based on the taxpayer's earned income in excess of \$10,000. The refundable portion of the child tax credit does not constitute income and is not treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any Federal program or any State or local program financed with Federal funds.

Non-EGTRAA Changes

Lower Capital Gains Rates - Qualified Five-Year Gain

For tax years beginning after December 31, 2000, gain from the sale or exchange of property held more than 5 years which would otherwise be taxed at the 10% rate instead is taxed at an 8% rate. Gain from the sale or exchange of property held more than 5 years, the holding period for which begins after December 31, 2000, which would otherwise be taxed at a 20% rate will be taxed at an 18% rate. For purposes of determining whether the holding period begins after December 31, 2000, the holding period of any property acquired pursuant to the exercise of

an option (or other right or obligation to acquire the property) includes the period such option (or other right or obligation) was held. Thus, the sale or exchange of property acquired after 2000, by exercising an option acquired before 2001, won't qualify for the 18% rate.

The 8% rate applies to post-2000 gain on qualifying assets held for more than five years, regardless of when the holding period began. Thus, some 2001 gain is automatically taxed at 8%. However, the 18% rate won't be available for gain realized before 2006, because the five-year holding period must begin after 2000 for that rate to apply. Thus, if property is sold by a taxpayer before 2006, the gain on the sale will be taxed at 8% to the extent it would otherwise be taxed at a rate below 25% (if it were ordinary income), and the balance of the gain will be taxed at 20%.

Deemed sale-and-repurchase election. A noncorporate taxpayer may elect to treat any readily tradable stock (which is a capital asset) or any other capital asset or property used in the trade or business (as defined in section 1231(b) of the Internal Revenue Code of 1986), held by the taxpayer on Jan. 1, 2001 (and not sold before Jan. 2, 2001), as having been sold on Jan. 2, 2001 for an amount equal to its closing market price or fair market value, on Jan. 2, 2001, and as having been reacquired on that date for an amount equal to the closing market price. The election does not apply to assets disposed of in a transaction in which gain or loss is recognized before the close of a one-year period beginning on the date that the asset would have been treated as sold under the election. Any gain recognized as a result of the election is recognized notwithstanding any other provision, and any loss resulting from the election is not allowed for any tax year. Once made, the deemed-sale-and-repurchase election is irrevocable.

The election is made by (1) reporting the deemed sale(s) on the timely filed return (including extensions) for the tax year that includes the deemed-sale date (calendar year taxpayers make the election on their 2001 tax returns), and (2) attaching a statement declaring that an election is being made under Section 311 of the Taxpayer Relief Act of 1997 and specifying the assets for which the election applies. If the taxpayer timely filed his tax return without making the election for any asset, he can still make the election by filing an amended return within 6 months of the due date of the return (excluding extensions). "Election Under Section 311 of the Taxpayer Relief Act of 1997" should be written at the top of the amended return. In other words, calendar-year taxpayers may make the deemed sale-and-repurchase election as late as Oct. 15, 2002.

The above rules for property held more than five years don't apply to collectibles gain, unrecaptured section 1250 gain, and section 1202 gain. Additionally, it is not possible to effect a deemed election for the purposes of qualifying the property and then exclude the gain under IRC § 121.

Individual Retirement Arrangements (IRAs)

The phase out limitations increase again for 2001, potentially making it easier for more service members to make deductible contributions to a traditional IRA. The phase out limits for IRA deduction increase this year for employees covered by qualified retirement plans. Because

service members are active participants and have coverage by a pension or retirement plan, deductible IRA contributions are subject to limitations. The adjusted gross income (AGI) limits are gradually increasing over the next several years. For 2001, married filing jointly, the phaseout begins at \$53,000 and tops out at \$63,000. In 2007 and thereafter the maximum range will be from \$80,000 to \$100,000. For single filers (including head of household), the phaseout begins at \$33,000 and ends at \$43,000. In 2005 and thereafter the maximum range will be from \$50,000 to \$60,000. For married filing separately the limit is remains \$10,000.

Due to EGTRRA expect to see increased contribution limits over the coming years. The Act increases the maximum annual dollar contribution limit for IRA contributions from \$2,000 to \$3,000 for 2002 through 2004, \$4,000 for 2005 through 2007, and \$5,000 for 2008. After 2008, the limit is adjusted annually for inflation in \$500 increments. The Act also provides for catch-up contributions. Individuals who have attained age 50 may make additional catch-up IRA contributions. The otherwise maximum contribution limit (before application of the AGI phase-out limits) for an individual who has attained age 50 before the end of the taxable year is increased by \$500 for 2002 through 2005, and \$1,000 for 2006 and thereafter.

Student Loan Interest Deduction

The student loan interest deduction continues to increase in value to the military taxpayer. For 2001, taxpayers can deduct up to \$2,500 of student loan interest. The Student Loan Interest Deduction is taken as an adjustment to income; taxpayers do not have to itemize to qualify for this deduction. However, the deduction declines for couples with adjusted gross income of \$60,000 to \$75,000. For single taxpayers, the deduction decreases with adjusted gross income of \$40,000 to \$55,000.

Currently, student loan interest deductions are limited to the interest paid during the first sixty months in which interest is required to be paid on an educational loan. Beginning with tax year 2002, EGTRRA repeals both the limit on the number of months during which interest paid on a qualified education loan is deductible. Further, EGTRRA increases the income phaseout ranges for eligibility for the student loan interest deduction to \$50,000 to \$65,000 for single taxpayers and to \$100,000 to \$130,000 for married taxpayers filing joint returns. These income phase-out ranges are adjusted annually for inflation after 2002.

Earned Income Credit (EIC)

The refundable EIC is available to certain low-income individuals who have earned income, meet adjusted gross income thresholds, and do not have more than a certain amount of disqualified income. Beginning in 2001, the EIC is denied if the aggregate amount of disqualified income exceeds \$2,450 (\$2,400 in 2000).

Tax Form Changes

The biggest change on the tax forms for 2001 is the addition of a line to claim the rate reduction credit discussed previously. Form 1040A adds line 30 and Form 1040 adds line 47, and treats the rate reduction credit as it would any other non-refundable credit. Form 1040EZ adds line 7, and treats any rate reduction credit due as addition to the credits, payments, and tax, essentially treating any rate reduction credit due as additional withholding or a refundable credit.

Additionally, all 3 tax forms include a space near the end of the return to appoint a “Third Party Designee.” Complete this if the taxpayer wishes to allow a friend, family member, or any other person to discuss his 2001 tax return with the IRS.

Mailing Locations for Tax Returns

Some taxpayers will mail their tax returns to a different IRS Service Center this year because the IRS changed the filing location for several areas. Taxpayers should mail tax returns to the address on the envelope received with their tax package, or note the proper mailing address

2001 NUMEROLOGY

Five tax rate brackets apply for 2001, taxed at the following marginal tax rates: 15%, 27.5%, 30.5%, 35.5% and 39.1%. (I.R.C. §§1(a); 1(b); 1(c); 1(d); & 1(i)(2))

A 10% rate bracket, which would otherwise apply, isn't in effect for 2001. It is made inapplicable for any tax year to which Code Sec. 6428 applies (i.e., the 2001 tax rate reduction credit and the advanced refund of that credit). (Code Sec. 1(i)(1)(A)(i) & Code Sec. 1(i)(1)(D)). Thus, for 2001, the rate-reduction credit applies in lieu of the 10% tax rate bracket for 2001. For 2002 and later years, a 10% tax rate bracket applies. (I.R.C. § 1(i)(1)(A)(i)). There is no 10% tax rate bracket for trusts and estates as there is for individuals.

The 2001 tax rates by filing status are:

Married filing jointly and Qualifying Widow(er):

<u>Taxable Income</u>	<u>Marginal Tax Rate</u>
\$1 - 45,200	15 %
45,200 - 109,250	27.5%
109,250 - 166,500	30.5%
166,500 - 297,350	35.5%
over 297,350	39.1%

Single:

<u>Taxable Income</u>	<u>Marginal Tax Rate</u>
\$1 - 27,050	15 %
27,050 - 65,550	27.5%
65,550 - 136,750	30.5%
136,750 - 297,350	35.5%
over 297,350	39.1%

Head of household:

<u>Taxable Income</u>	<u>Marginal Tax Rate</u>
\$0 - 36,250	15 %
36,250 - 93,650	27.5%
93,650 - 151,650	30.5%
151,650 - 297,350	35.5%
over 267,350	39.1%

Married filing separately:

<u>Taxable Income</u>	<u>Marginal Tax Rate</u>
\$1 - 22,600	15 %
22,600 - 54,625	27.5%
54,625 - 83,250	30.5%
83,250 - 148,675	35.5%
over 148,675	39.1%

Estates and trusts:

<u>Taxable Income</u>	<u>Marginal Tax Rate</u>
\$1 - 1,800	15 %
1,800 - 4,250	27.5%
4,250 - 6,500	30.5%
6,500 - 8,900	35.5%
over 8,900	39.1%

Standard Deduction

Married filing jointly or qualifying widow(er) – 2001: \$7,600 (\$7,350 in 2000; \$7,850 projected for 2002).

Single – 2001: \$4,550 (\$4,400 in 2000; \$4,700 projected for 2002).

Head of household – 2001: \$6,650 (\$6,450 in 2000; \$6,900 projected for 2002).

Married filing separately – 2001: \$3,800 (\$3,675 in 2000; \$3,925 projected for 2002).

Reduction of Itemized Deductions

Married filing separately - \$66,475.

All other returns - \$132,950.

Personal Exemptions

Higher personal exemption deduction – 2001: \$2,900 (up from \$2,800 in 2000; \$3,000 projected for 2002).

2001 Phase Out Amounts for personal exemptions:

<u>Taxpayer</u>	<u>Begins After</u>
Married filing jointly	\$199,450
Single	\$132,950
Head of household	\$166,200
Married filing separately	\$ 99,725

Foreign Earned Income Exclusion

Higher exclusion for 2001: \$78,000 (was \$76,000 in 2000; will be \$80,000 in 2002 and thereafter).

Earned Income Credit

Number of Children	Maximum Amount of the Credit	Earned Income Amount	Threshold Phaseout Amount	Completed Phaseout Amount
1	\$2,428	\$7,100	\$13,100	\$28,281
2 or more	\$4,008	\$10,000	\$13,100	\$32,121
None	\$364	\$4,750	\$5,950	\$10,710

Auto Standard Mileage Allowances

If a taxpayer can use an automobile for business, medical, charity, and/or moving purposes, the taxpayer is allowed a standard mileage deduction rate. For 2001, the rates are:

Business: 34.5 cents per mile

Charity: 14 centers per mile

Medical or Moving: 10 cents per mile

**2001
TAX
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**2001 FEDERAL
INCOME TAX TIPS**

This pamphlet provides information concerning your federal income taxes. If you have legal questions concerning your taxes, and your unit tax advisor is unable to answer them, call the number below for an appointment to see a lawyer.

**LEGAL ASSISTANCE TELEPHONE
NUMBER**

OFFICE OF THE STAFF JUDGE ADVOCATE

FEDERAL INCOME TAX TIPS

Below are several tax tips for publishing in post bulletins during the tax-filing season.

1. TAX TIP: In calculating whether I qualify for the earned income credit, what entitlements must I include? You must add "earned income" (wages, salaries, tips, and other employee compensation) with your quarters allowance (minimum BAH) (whether or not actually received), subsistence (BAS) and combat pay. You do not include VHA or COLA. This will be indicated on the Form W-2, Box 12, Q.
2. TAX TIP: When should I receive my W-2 forms from my employers? Not later than 31 January. By federal law, employers have until this date to furnish you your W-2 forms.
3. TAX TIP: When should I receive my statements of dividends and interest from my financial institutions? Not later than 31 January. By federal law, financial institutions have until this date to furnish you these statements.
4. TAX TIP: What should I do if I do not receive a W-2 from my employer or statements of dividends/interest from my financial institutions by 31 January? Write the employer and if this fails, write the IRS Center that services the employer/institution and complain to them. Contact the Legal Assistance Office for the IRS Center address.
5. TAX TIP: The W-2 income report I received in the mail has a huge computer error. It shows I earned \$200,000 rather than \$20,000. Can I just ignore the extra zero? Only if you want to hear from the IRS. Since your employer sent the same W-2 to the IRS, they will expect tax on \$200,000. You should contact your employer and ask for a revised W-2.
6. TAX TIP: When do I have to make a contribution to an Individual Retirement Account (IRA) for a deduction on my 2001 tax return? Stateside and overseas taxpayers have until 15 April 2002. Soldiers stationed in a combat zone who have not already filed their federal income tax return may have a longer period and should contact a military attorney if they need tax advice on IRA contributions.
7. TAX TIP: Can I claim an IRA deduction on my tax return although I have not actually created one yet? Yes, if you in fact create one not later than 15 April 2002.
8. TAX TIP: What is the filing date for taxpayers overseas? If you primarily live and work outside the U.S. and Puerto Rico on 15 April 2002, you have until 17 June 2001 to file your return. Simply put on the outside of your envelope: "Outside the U.S. on 15 April 2001," to take advantage of the automatic extension. NOTE: Taxpayers who are merely traveling outside the U.S. or Puerto Rico on 15 April 2001 are not entitled to an automatic two-month filing extension.

9. TAX TIP: If my move to a new assignment began in 2001 and ended in 2002, when do I file my moving expenses? You have two choices - file them all on your 2001 tax return, or file your 2001 expenses on your 2001 return and your 2002 expenses on your 2002 return. Moving expenses are now an adjustment to gross income and no longer include certain indirect moving expenses. See the Moving Expense Deduction flyer for more information.
10. TAX TIP: What form do I use to file for my moving expenses? Form 3903 if your move was to or within the U.S., and Form 3903F if your move was outside the U.S. or its possessions.
11. TAX TIP: How long do I have to reinvest my gain from the sale of my old personal residence into a new personal residence if I sold a home before 07 May 1997? Civilians have two years (four years if overseas), and military members have four years (stateside or overseas). This replacement period is suspended while military members are stationed outside the United States. NOTE, however, that the replacement period, plus any period of suspension, cannot last more than eight years after the sale of the home, except for suspensions resulting from periods of service in, or in support of, a combat zone or Qualified Hazardous Duty Area (QHDA).
12. TAX TIP: How much of a charitable contribution can I deduct without itemizing? None, you can only take charitable contribution deductions by itemizing on the Schedule A, Form 1040.
13. TAX TIP: How can I claim the out-of-pocket expenses I incur in traveling from place to place during my workday? You use the Form 2106, Employee Business Expenses, and Schedule A, Itemized Deductions, and list your actual travel expenses or apply a flat 34.5 cents per mile.
14. TAX TIP: How do I report the Employee Business Expense deduction on my tax return? You must itemize (i.e., use the Form 2106 and the Schedule A) to claim these expenses.
15. TAX TIP: Where do I mail my tax return if I am an overseas taxpayer? You should send your return to Internal Revenue Service Center, Philadelphia, Pennsylvania 19255.
16. TAX TIP: Can I deduct my unreimbursed travel expenses in using my POV to do charity work? Yes, you can deduct your actual expenses or use a flat rate of 14 cents per mile (plus tolls and parking fees). There are, however, restrictions if your travel involves being away from your home (e.g., taking a trip to another state to do charitable services). There must be no significant element of personal pleasure, recreation, or vacation in the travel. Finally, you can only take charitable contribution deductions by itemizing, using the Schedule A.
17. TAX TIP: What are the rules for tax on capital gains? Assets sold after 1 January 1998 that are held for 12 months or longer are taxed at a maximum rate of 20%. If you are in the 15% tax bracket, the sale of these assets is taxed at a 10% rate. For tax years beginning after December 31, 2000, gain from the sale or exchange of property held more than 5 years, which would otherwise be taxed at the 10% rate, instead is taxed at an 8% rate.

18. TAX TIP: If I am renting out a home, over how many years can I depreciate the structure? It depends on when you purchased it and when you started renting it out. Depending on these issues, the answer to this question is 15, 18, 19, or 27.5 years. Homes rented out for the first time after 1986 are depreciated over 27.5 years.
19. TAX TIP: Can military personnel avoid reporting housing allowances and yet still take deductions for their mortgage interest payments and real estate taxes? Yes. The Tax Reform Act of 1986 created a specific statutory right for military taxpayers to do this.
20. TAX TIP: How much money earned overseas from U.S. Government sources is excludable as Foreign Earned Income (FEI)? None. FEI is income you earn while overseas, which is not earned from the U.S. Government.
21. TAX TIP: How can I get forms and publications? Forms and publications are available on the Internet at <http://www.irs.ustreas.gov/>. You can also call the IRS toll-free order number 1-800-TAX-FORM (1-800-829-3676). You can also get them by visiting your installation Tax Center.
22. TAX TIP: Is money I earn as a child care provider in an overseas area excludable as Foreign Earned Income? Yes. If you meet the residency or physical presence test requirements, you can exclude the money you have earned from your income.
23. TAX TIP: Is money I earn while teaching a course overseas excludable as Foreign Earned Income? Usually, yes. You are probably an independent contractor and not an employee of the U.S. Government. Therefore, if you meet the residency test or physical presence test requirements, you can exclude the money you have earned from your income.
24. TAX TIP: What are the rules for claiming the child tax credit? Taxpayers can claim a child tax credit of \$600 for each “qualifying child” under the age of 17 for whom the taxpayer claims an exemption. The amount of the child tax credit is subject to limitations based upon the taxpayer’s modified adjusted gross income (MAGI). This is now a refundable credit under the 2001 Tax Act. The child tax credit will first eliminate any federal tax owed. Then taxpayers are eligible for a refund based on the following formula. The refund is equal to the lesser of the unused credit or 10% of the amount family earnings exceed \$10,000. Use form 8812 to figure whether a refund of the credit is allowed.

25. TAX TIP: I sold a house last year. Do I have to pay taxes on the gain? It depends. If you lived in it for two of the previous five years, you do not have to pay any gain on the sale (provided the gain was under \$250,000, if single, or \$500,000, if married filing jointly). If you sold your home prior to 7 May 1997, you do not have to pay any taxes on the sale (provided the home was your principal residence and you purchase a replacement home of equal or greater value during the replacement period).

26. TAX TIP: What do I do with an overweight charge I received in 2001 for a previous year's PCS move? You deduct it from your 2000 tax return using the Form 3903 or 3903F and a Schedule A. You do not amend the tax return of the year you had the PCS move.

27. TAX TIP: Is the cost of a finder's fee to locate a new personal residence when I PCS a deductible moving expense? Not any more. The Omnibus Budget Reconciliation Act of 1993 narrowed moving expenses to only the direct costs of moving your household goods and you and your family.

28. TAX TIP: What are the rules for proving employee business expenses? You need adequate written records of your expenditures. Ideally, they should be prepared as near to the time of the expense as possible. The IRS tends to view records created later, when there is less likelihood of accurate recall, with disfavor.

29. TAX TIP: What is the maximum deductible IRA contribution that may be made by a couple filing jointly, where one spouse has earned income? \$4,000 (no more than \$2,000 in either spouse's IRA). This *may be limited*, however, if adjusted gross income exceeds \$53,000.

30. TAX TIP: What is the maximum IRA contribution that can be made by a couple filing jointly if one spouse has no income? A maximum of \$4,000 can be contributed in 2000. Again, no more than \$2,000 can be deposited into either spouse's IRA. The ability to deduct this contribution is limited, however, if adjusted gross income exceeds \$53,000 for a married taxpayer or \$33,000 for a single taxpayer. A different phase limitation applies to a spouse that is not a participant in a pension plan (\$150,000).

31. TAX TIP: Can I exclude Foreign Earned Income, and still take the Child Care Credit for child care costs attributable to the Foreign Earned Income? No.

32. TAX TIP: Can I exclude Foreign Earned Income and take a Foreign Tax Credit for the foreign taxes attributable to the Foreign Earned Income? No.

33. TAX TIP: Where do I claim the annual fee for my safe-deposit box? Assuming you keep investment or tax-related documents in the box, the cost is considered a miscellaneous expense. Include it with other expenses in this category and deduct the amount by which the total exceeds 2% of your adjusted gross income using Schedule A (Form 1040).

34. TAX TIP: Are foreign sales taxes deductible from your income for federal income tax purposes? Usually, no. Only if you are in a business where you pay taxes on your supplies, might they be deductible.

35. TAX TIP: Are state and local sales taxes deductible anymore? No, the Tax Reform Act of 1986 rescinded this deduction.

36. TAX TIP: I am stationed overseas and would like my spouse to file on my behalf. Can she prepare the joint return and sign my name to it? Yes, if she has a power of attorney authorizing her to do so. The IRS will accept a general power of attorney for this purpose if it specifically mentions tax matters. Your local Legal Assistance Office can prepare an appropriate power of attorney for you.

37. TAX TIP: Jane earned \$2,300 providing child care for fellow Americans in Korea last year. How much of it is subject to income tax? None -- if she meets either the residency test or physical presence test requirements, she can exclude the money she earned from her income using the Foreign Earned Income exclusion. By filing Form 2555 (or Form 2555EZ), Jane can exclude it from her taxable income. Note, however, that the earnings may be subject to self-employment tax.

38. TAX TIP: What is the maximum amount of moving expenses I can deduct for travel, meal, and lodging expenses in moving from the old to the new residence? The full amount of the travel and lodging expenses may be deducted, but only if they exceed all reimbursements (including dislocation allowances) that the taxpayer has received (This is unlikely in the military). Further, meal costs are not deductible as a moving expense.

39. TAX TIP: If stateside, and I can not make the 15 April 2002 filing deadline, or overseas and can not meet the 17 June 2002 deadline, what can I do? Fill out Form 4868 and receive an automatic extension to 15 August 2002 (for both stateside and overseas taxpayers). Pick up this form at your Legal Assistance Office. Note, however, that an extension of time to file does not extend the time to pay the tax. If, on filing the Form 4868, you underpay the tax owed, the IRS will charge interest on the unpaid amount from 15 April 2002.

40. TAX TIP: My 10-year-old son earned \$600 from a bank account in 2001. Must he file a return? No. Children under 14 must file a return if their income from investments exceeds a total of \$750 in 2001 or the total of their unearned income (e.g., interest and dividends) and any earned income (e.g., wages) exceeds \$4,550.

41. TAX TIP: May I deduct my credit card and car loan interest paid? No, interest paid on these personal loans is not deductible.

42. TAX TIP: How much is the "standard deduction" for 2001? For 2001, the standard deduction is \$4,550 if single, \$6,650 if Head of Household, \$7,600 if Married Filing Joint or Widow(er), and \$3,800 if Married Filing Separate. Persons 65 or older, or blind, have a special, higher standard deduction.

43. TAX TIP: How much is the personal exemption for 2001 tax returns? The personal exemption for 2001 is \$2,900.

44. TAX TIP: If you plan to claim an exemption for a dependent who was born during 2001, you must have a social security number for the dependent, and report it on your 2001 tax return.

45. TAX TIP: I received a house with a fair market value of over \$100,000 because of a divorce decree. Do I include this transfer on my tax return? No. Property transferred between spouses because of a divorce is not subject to tax upon transfer. You may be responsible for paying tax on the gain you realize when you sell the home.

46. TAX TIP: I own my own home and live alone. Since I am the only person in the household, can I use the head-of-household tax rates? No. To qualify as an unmarried head of household, and benefit from rates lower than those that apply to single people, you must pay more than half the cost of maintaining a home where you live with a "qualifying individual" (e.g., child, stepchild, adopted child, foster child, or grandchild).

47. TAX TIP: I gave a check to my church at Christmas time, but it was not cashed until the following year. Can I deduct the amount for the year I gave the check, or do I have to wait? You can claim the deduction on the return for the year you gave the check.

48. TAX TIP: Has the investment interest limitation changed in 2001? No, as in last year, investment interest (that is, interest paid or accrued on debts incurred to buy or carry investment property) is deductible only up to net investment income.

49. TAX TIP: Who may qualify to file as "qualifying widow(er)?" If your spouse died in either 1999 or 2000, then for the purposes of your 2001 filing status, you are a qualifying widow(er) and you may use joint return rates on your 2001 return provided you meet all the following requirements: you did not remarry before 2001; a dependent child, stepchild, adopted child, or foster child lived with you during 2001 and you paid over half the cost of maintaining your home; and you were able to file jointly in the year of your spouse's death, even if you did not actually do so.

50. TAX TIP: How do I correct mistakes I made on my income tax return? Use Form 1040X, AMENDED U.S. INDIVIDUAL INCOME TAX RETURN, to correct Forms 1040, 1040A, 1040EZ, and 1040NR.

51. TAX TIP: When should I file Form 1040X? File Form 1040X only after you have filed your original Form 1040. Generally, Form 1040X must be filed within 3 years after the date the original return was filed or within 2 years after the date the tax was paid, whichever is later.

52. TAX TIP: Does the IRS recommend a method of record keeping? You must keep accurate records, but the IRS does not require a particular method. You should keep sales slips, invoices, receipts, canceled checks, and financial account statements in order to verify the deductions and credits shown on your return. Also keep Forms W-2, WAGE AND TAX STATEMENT; Forms 1099 showing interest, dividends, distributions; stock brokerage statements; and any other documents that prove the amounts shown on your return as income.

53. TAX TIP: How do I get a copy of my return? You can request a copy of your return and all the attachments (including Form W-2) by sending Form 4506 to the IRS. There is a \$23 fee for a copy of your return, which must be paid with Form 4506; but there is no charge for only a copy of Form W-2.

54. TAX TIP: What records do I need to keep as a homeowner? You should keep records that show the basis of your property. The basis is usually the cost of your property. You must keep records of the purchase price of your home, any purchase expenses, the cost of any improvements, and any other basis adjustments, such as depreciation and deductible casualty losses. If you sold your old home and postponed tax on the gain from the sale, you should keep information from the old home, too.

**2001
TAX
INFORMATION
SERIES**

**STANDARD &
ITEMIZED
DEDUCTIONS**

This pamphlet provides information concerning your federal income taxes. If you have legal questions concerning your taxes, and your unit tax advisor is unable to answer them, call the number below for an appointment to see a lawyer.

**LEGAL ASSISTANCE TELEPHONE
NUMBER**

OFFICE OF THE STAFF JUDGE ADVOCATE

STANDARD & ITEMIZED DEDUCTIONS

A. Introduction. This flyer covers itemized deductions, such as medical expenses, taxes, and casualty losses. The taxpayer may choose to itemize or take the standard deduction. If the itemized deductions are not greater than the standard deduction, the standard deduction is preferable. A taxpayer may change his mind even after filing the Form 1040 return by filing an amended return, Form 1040X.

B. Standard Deduction. IRC Section 63(c).

1. The 2001 basic standard deduction amounts are:

<u>Filing Status</u>	<u>Amount</u>
Joint returns/Widow	\$7,600
Heads of households	6,60
Single individuals	4,550
Married filing separately	3,800

2. Additional basic standard deduction amounts are provided for the elderly and the blind.

3. A dependent claimed on the taxpayer's return is entitled to a standard deduction of the greater of \$750 or earned income (up to \$4,550). A "dependent" is defined in IRC Section 152. Just about any relative of the taxpayer qualifies as a "dependent" if the taxpayer provides over half the support (children, parents, grandparents, etc.). Also a non-relative, who lives in the household for the entire year, will qualify if the taxpayer provides over half of the support.

4. The following are not eligible for the basic standard deduction:

Married filing separately where either spouse itemized.

Nonresident alien.

Person changing accounting period and return for less than 12 months.

Estate, trust, or partnership.

C. Itemized Deductions.

1. Deductions must be authorized--that is, the taxpayer must be able to point to some authority to justify any deduction. The authority may be found in the code, regulations, cases, or revenue rulings.

2. Otherwise allowable itemized deductions are reduced if 2001 adjusted gross income exceeds \$132,950 (\$66,475 for married filing separately). Itemized deductions subject to this provision do not include medical expenses, investment interest, or wagering losses. All other limitations apply first. Disregard this when calculating Alternative Minimum Taxable Income.

3. Miscellaneous deductions. IRC Section 67(a). The following types of itemized deductions are allowed only to the extent they exceed 2% of adjusted gross income (AGI):

- Professional society dues
- Employment related educational expenses
- Office-in-home expenses
- Expenses of looking for a new job
- Professional books, magazines and journals
- Work clothes and uniforms (But generally not military uniforms, except insignia)
- Union dues and fees
- Certain unreimbursed employee business expenses
- Safe deposit box rental
- Tax counsel and assistance
- Cost of work-related small tools and supplies
- Investment counsel fees
- Fees paid to an IRA custodian
- Expenses allocated to shareholders or mutual funds and other publicly offered regulated investment companies

4. These deductions are not subject to the 2% floor:

- Casualty/theft losses. IRC Section 165(c)(3)
- Medical expenses. IRC Section 213(a)
- Taxes. IRC Section 164
- Interest. IRC Section 163(h)

D. Medical and Dental Expenses: These are deductible only to the extent they exceed 7.5% of AGI. The following is a checklist of items that are deductible as medical expenses:

- Fees for medical services
- Fees for hospital services
- Meals and lodging provided by a hospital during medical treatment
- Medical and hospital insurance premiums
- Special equipment such as wheelchairs, eyeglasses, artificial limbs, hearing aids, crutches, etc.
- Medicines and drugs that require a prescription (includes programs to stop smoking)
- Drug/alcohol treatment center expenses
- Legal abortions
- Transportation essential for medical care (deductible at 12 cents a mile).
- Smoking cessation programs.

A taxpayer **cannot** deduct the following as medical expenses:

- Illegal drugs
- Medicare A basic insurance costs, but Medicare B (supplemental premiums for over 65) can be deducted
- Nursing care for a healthy baby
- Weight loss programs
- Health club dues

A taxpayer can deduct the premiums paid for insurance which will be used to reimburse for medical costs. Medicine and drugs must be prescribed by a doctor or be insulin. The expenses must actually be paid during the year. The expenses must not be compensated by insurance or otherwise.

The taxpayer is eligible to take the deduction for expenditures for the spouse or a dependent of the taxpayer if the spouse or dependent is a spouse or dependent of the taxpayer either at the time medical services are rendered or when paid. Dependent is defined by the dependency exemption rules of IRC Section 151. There is a special rule for a child of divorced parents -- the party actually paying the qualifying child's medical expenses may deduct them.

Expenses for cosmetic surgery or other similar procedures are no longer deductible, unless surgery or procedure is necessary to improve a deformity arising from, or directly related to a congenital abnormality, a personal injury resulting from accident or trauma, or disfiguring disease. IRC Section 213(d)(9). Cosmetic Surgery is any procedure which is directed at improving the patient's appearance and does not meaningfully promote the proper function of the body or treat illness or disease.

E. Casualty/Theft Losses: The loss must be a sudden and unexpected loss for nonbusiness property. The types of losses are as follows:

- Fire
- Storm
- Shipwreck
- Other casualty
- Theft

Bankruptcy or insolvency of financial institution-taxpayer can elect to treat as bad debt under IRC Section 166-Note the loss would equal the difference between the deposit and the expected return. IRC Section 165(l). Bad debt losses are treated as short-term (held less than one year) capital losses. IRC Section 166(d).

The following are considered nondeductible losses:

- Progressive deterioration
- Termite or moth damage
- Diseases
- Drought

The amount of loss equals the lesser of the decrease in fair market value (FMV) or the adjusted basis. Sentimental value is not considered. Also, a general decline in FMV because in or near an area that suffered casualty or might suffer another casualty is not deductible. Further, the cost of protecting property against casualty or theft is not deductible.

There are many limitations on deducting casualty losses. If the loss is covered by insurance, a claim must be filed with the insurance company. Then, the deduction must be reduced by the amount of the insurance or other compensation. The taxpayer must reduce each casualty/theft loss by \$100. The taxpayer must reduce the total casualty/theft losses during the tax year by 10% of AGI. Any remaining casualty or theft loss is claimed on the Schedule A.

There are a couple of special rules. If losses exceed gains (gains result from involuntary conversion), then only the excess losses over gains are subject to the 10% of AGI rule. If gains exceed losses, they are treated as capital gains.

F. Taxes: Taxpayers can deduct state, local and foreign real and personal property taxes, and income taxes. They can also deduct other taxes imposed by such jurisdictions for carrying on a trade or business or for producing income. The following state and local taxes are not deductible:

- General sales taxes
- Excise taxes
- Motor vehicle taxes
- Inheritance taxes
- Gift taxes
- Per capita or poll taxes
- Tobacco or liquor taxes
- Taxes on gasoline or motor fuels
- Fees or charges such as:
 - Driver's licenses
 - Tolls
 - Hunting licenses
 - Fines
 - Utility bills
- Transfer taxes on sale of home; however, if paid by seller, they can reduce amount realized; if paid by buyer they can be added to basis.

Real property taxes are deductible when paid by the taxpayer. Usually taxes paid by a tenant to a landlord are treated as additional rent so they are not deductible. When real estate is sold, the seller and buyer each deduct a pro-rata share of the real property tax based on the number of days each owns the property.

General sales taxes are not deductible. Foreign taxes are deductible if real property, income, war profits, or excess profits or are paid to produce income. Income, war profits, and excess profits taxes paid can be taken as a credit against United States income rather than as an itemized deduction. Either credit or deduction can be taken in the year paid.

See IRS Publication 501, Exemptions, Standard Deduction, and Filing Information, and IRS Publication 529, Miscellaneous Deductions, for more information.

**2001
TAX
INFORMATION
SERIES**

**INDIVIDUAL
RETIREMENT
ARRANGEMENTS**

This pamphlet provides information concerning your federal income taxes. If you have legal questions concerning your taxes, and your unit tax advisor is unable to answer them, call the number below for an appointment to see a lawyer.

**LEGAL ASSISTANCE TELEPHONE
NUMBER**

OFFICE OF THE STAFF JUDGE ADVOCATE

INDIVIDUAL RETIREMENT ARRANGEMENTS

A. INTRODUCTION.

Individual Retirement Arrangements (IRAs) are one of the most popular investments. An IRA is a personal savings plan that lets you set aside money for your retirement.

Contributions to an IRA may be tax deductible and the earnings in an IRA are not taxed until they are distributed.

The deduction a person can take for contributions to an IRA depends on:

- 1) whether the taxpayer is covered by an employer-provided retirement plan,
- 2) how much income that person has, and
- 3) the person's filing status.

A person who is not covered by an employer-provided retirement plan may still take a full IRA deduction of up to \$2,000, or 100% of earned compensation, whichever is less. Taxpayers covered by an employer-provided retirement plan may be entitled to only a partial deduction or to no deduction at all, depending on how much income they have.

B. COVERAGE BY AN EMPLOYER-PROVIDED PLAN.

An employer-provided retirement plan is one that is set up by the employer who then makes contributions to the plan for the benefit of the employees. Employees who are not certain whether they are covered by an employer's retirement plan should ask their employer.

Members of the Armed Forces on active duty for 90 days or more are considered covered by an employer-provided plan even if they have served less than 20 years in the military. The Form W-2 (Wage and Tax Statement) that the employee receives at the end of the year from the employer will show whether or not the employee is covered. There will be a check in the "Pension Plan" box if the employee is covered. Coverage under social security or railroad retirement rules does not count as coverage under an employer's retirement plan for this purpose. People who are receiving retirement benefits from a previous employer's plan, e.g., retired members of the military services, are not considered covered by that plan for this purpose. If they are self-employed or working for another employer and are not covered by any other retirement plan, they may still be entitled to a full IRA deduction.

For the purposes of the IRA deduction rules, an employer-provided retirement plan is any of the following:

- 1) A qualified pension, profit-sharing, stock bonus, money purchase, etc., plan;
- 2) A qualified annuity plan;
- 3) A plan established for its employees by a federal, state, or local government, or any of its political subdivisions, agencies, or instrumentalities (other than an eligible state-deferred compensation plan);
- 4) A tax-sheltered annuity plan for employees of public schools and certain tax-exempt organizations;
- 5) A simplified employee pension (SEP); or
- 6) A trust that is funded only by employee contributions.

C. ADJUSTED GROSS INCOME LIMITATION.

Those who are covered by an employer's retirement plan may be entitled to only a partial deduction or no deduction at all, depending on their adjusted gross income (AGI). The deduction begins to decrease when the taxpayer's AGI reaches a certain level and is eliminated completely when it reaches a higher level. The deduction is reduced, and eventually eliminated entirely, depending on the taxpayer's filing status and income as follows:

<u>If filing status is:</u>	<u>Deduction reduced when AGI within phase-out range of:</u>	<u>Deduction is eliminated if AGI is:</u>
Single, or Head of Household	\$33,000 - \$43,000	\$43,000 or more
Married, joint return or Qualifying widow(er)	\$53,000 - \$63,000	\$63,000 or more
Married-separate return	\$ -0- - \$10,000	\$10,000 or more

Those subject to the phase out may still be entitled to a partial deduction as explained on the next page.

D. HOW TO FIGURE PARTIAL DEDUCTION.

Individuals covered by an employer-provided plan and whose income is within the AGI phase-out range should figure the partial deduction as follows:

Maximum Partial Deduction

(Use this Worksheet only if AGI is within phase-out range)

Enter the amount below on line (1):

- | | | |
|----|--|--------------|
| 1) | If filing status is: | |
| | Single, or Head of Household | \$43,000 |
| | Married, joint return or qualifying widow(er) | \$63,000 |
| | Married - separate return | \$10,000 |
| | | (1) \$ _____ |
| 2) | Adjusted gross income | (2) \$ _____ |
| 3) | Subtract line 2 from line 1 | (3) \$ _____ |
| 4) | Maximum partial deduction, Multiply line 3 by 20% (.20). If the result is not a multiple of \$10, round it to the next highest multiple of \$10 (for example, \$611.40 is rounded to \$620). However, if the result is less than \$200, enter \$200. | (4) \$ _____ |

A taxpayer may deduct IRA contributions up to the amount shown on line 4 of the worksheet, or 100% of his taxable compensation for the year, whichever is less.

The amount on line 4 has a \$200 floor. For example, if line 4 is \$100, a taxpayer can still deduct \$200. If the amount on line 4 is zero, however, no deduction is allowed.

E. ROTH IRAs.

Unlike the traditional IRA, contributions to a Roth IRA are not tax-deductible. However, just as with the traditional IRA, earnings grow tax deferred. A major distinction and advantage the Roth IRA has over the traditional IRA, is that its earnings can be withdrawn tax-free after age 59 1/2 if the account has been in place for at least five years. If the taxpayer meets this 5-year test, the Roth IRA permits early withdrawals without penalty for the purchase of a first home - the traditional IRA does but the amount withdrawn must be included in income; sets no maximum age limit for contributions - taxpayers may not contribute to a traditional IRA after age 70-1/2; and imposes no schedule for withdrawals - a traditional IRA requires annual withdrawals of a set amount.

Contributions:

Since Congress created IRAs with a tax advantage, it has limited the amount taxpayers may contribute. Annual contribution to a Roth IRA is limited to the lesser of \$2,000 or the taxpayer's compensation includible in his gross income for the year. For soldiers, compensation includes base pay, jump pay, flight pay, or any other pay received upon which taxed is imposed. It does not include Basic Allowance for Housing (BAH), Basic Allowance for Subsistence (BAS), or other untaxed compensation.

The maximum allowable contribution to a Roth IRA is reduced by any amount the taxpayer may have already contributed to a regular IRA for the same year. If the taxpayer has compensation exceeding \$2,000 for the year - he may contribute up to \$2,000 to a Roth IRA. However, if the taxpayer makes a tax-deductible contribution of \$1,000 to a traditional IRA, he may only contribute up to \$1,000 to a Roth IRA.

The maximum contribution limit is also reduced or completely phased out if the taxpayer's income exceeds certain limits. Contribution limits begin to be reduced when modified adjusted gross income exceeds \$95,000 for a single taxpayer; \$150,000 for a married taxpayer who files a joint return with his spouse; or \$0 for a married taxpayer who files a separate tax return from his spouse. A taxpayer may not make any contribution to a Roth IRA if she is a single taxpayer whose modified adjusted gross income exceeds \$110,000; \$160,000 if she is married and files jointly; or \$15,000 if she is married and files a separate return.

"Modified adjusted gross income" is a difficult, but not incomprehensible subject. However, do not assume it is the same as compensation. In addition to compensation, modified adjusted gross income includes interest, dividends, or alimony received. However, certain amounts paid, such as alimony, lowers modified adjusted gross income. Just remember, modified adjusted gross income may not simply be the amount found on the bottom line of the front page of Form 1040 - marked 'adjusted gross income.'

Excess Contributions to Your Roth IRA:

If the taxpayer made a larger annual contribution than allowed because her modified adjusted gross income was higher than expected, she may transfer the excess to a traditional IRA. Deductibility under the rules for a traditional IRA depends on income and whether the taxpayer is an active participant in an employer-sponsored plan. (For purposes of deduction for contributions to an IRA, Armed Forces members, including reservists on active duty for more than 90 days, are considered active participants in an employer-sponsored plan.) The transfer must include all the earnings on that contribution. Failing to make this transfer could subject the excess contribution to a 6% excise tax.

Roth IRA conversions:

If the taxpayer's adjusted gross income does not exceed \$100,000 she can convert her traditional IRA into a Roth IRA. The \$100,000 limit applies to the year in which the actual distribution from the non-Roth IRA occurs. This same \$100,000 limit applies to both single taxpayers and the joint income of married taxpayers who file joint returns. However, if the taxpayer is married and files separately she cannot make a Roth IRA conversion - no matter what her modified adjusted gross income. If the taxpayer makes the switch from a traditional IRA to a Roth IRA, the amount transferred is included in her income and she will owe taxes on the amount transferred.

There are three ways to convert a traditional IRA into a Roth IRA. The taxpayer can take a distribution from her traditional IRA and roll it into a Roth IRA within 60 days of the distributions. The taxpayer can transfer the amount in your traditional IRA at one financial institution directly to her Roth IRA at another financial institution in a "trustee-to-trustee" transfer. The taxpayer can also transfer amounts in a traditional IRA to a Roth IRA at the same financial institution. In this last example, the taxpayer does not need to physically transfer the assets, but the instrument governing the traditional Roth IRA must be replaced by a Roth IRA instrument.

Of these methods, personally taking the distribution is the least desirable. Financial institutions may be required to withhold taxes on the distribution. This means that the taxpayer will not receive the full amount necessary to complete a rollover. She will find it necessary to make up this difference with other funds. If the taxpayer fails to rollover the entire amount of the distribution, that is the amount that was in the traditional IRA before tax withholding, she may be assessed a 10% penalty tax for early withdrawal.

The conversion amount is generally includible in income for the conversion year. However, if the taxpayer made this switch before 1 January 1999, she could spread the income evenly over four years. The \$100,000 modified adjusted gross income limit does not include the amount rolled over.

For example, if the taxpayer with a modified adjusted gross income of \$80,000 rolls over a traditional IRA with a taxable balance of \$40,000, she would have \$40,000 of income. If

she makes the rollover before 1 January 1999, she can spread the income over four years, reporting only \$10,000 per year from 1998 through 2001. The \$10,000 added to modified adjusted gross income for the next four years is not included for purposes of meeting the \$100,000 limit when determining eligibility for future rollovers. Please remember that the taxpayer must rollover the entire amount withdrawn within 60 days to avoid incurring a 10% penalty on the non-converted amount!

A taxpayer who converts a traditional IRA to a Roth IRA, must be prepared to leave the full amount in the Roth IRA for at least 5 years. If the taxpayer fails to do so, she must immediately include in income the entire deferred amount. Additionally, there will be a 10% penalty tax on the amounts withdrawn.

Taxpayers were not required to use the 4-year spread for 1998 conversions. Instead, they could include the entire taxable amount due to the conversion in 1998 income. Although, deferring income to a later year is normally desirable, taxpayers may want to include the conversion amount in 1998 income if that income will be unusually low, (e.g., taxpayer was stationed in Bosnia and earned pay for that period tax-free) or if the taxpayer expects much higher income levels during the next 3-years.

If the taxpayer dies before the end of the 4-year spread, any remaining includible portion of the conversion amount will be included in income for the year of death. The surviving spouse-beneficiary may elect to continue application of the 4-year spread. However, this election may be made only if the surviving spouse is the sole beneficiary of all your Roth IRAs.

Five Year Holding Period:

To be tax free, a distribution of earnings from a Roth IRA must be after the taxpayer reaches age 59 1/2, to pay certain first-time homebuyer expenses, or because of the disability or death of the taxpayer. However, even if one of these conditions is met, a distribution of earnings is only tax free if it is made after the five-year holding period. The holding period begins with the year that the first contribution or rollover is made to any of the taxpayer's Roth IRAs.

To illustrate, a taxpayer contributes \$2,000 to a Roth IRA in 2000. In 2001, he rolls over \$10,000 to his Roth IRA from a traditional IRA. (The taxpayer will be taxed on the entire \$10,000 in 2001 - the ability to spread the distribution over 4-years only applies to 1998.) In 2005, the taxpayer may withdraw up to \$10,000 tax-free to purchase a first home even if the amount withdrawn includes earnings on the amount rolled over in 2001. This is so since, the purchase of a first home is one of the conditions that permits a tax free withdrawal of up to \$10,000, and the withdrawal will not be made until after the five-year period (2000-2004). Remember, the five-year period includes the year the first contribution was made to the Roth IRA.

Distributions from a Roth IRA:

Qualified distributions from a Roth IRA are not includible in gross income. A qualified distribution is one that is both (1) made after the end of the 5-tax-year period that begins with the first tax year for which the taxpayer first makes any regular or conversion contribution to a Roth IRA, and (2) is made under any of the following circumstances:

- at any time after the Roth IRA owner reaches age 59-1/2,
- to a beneficiary (or to the estate) of the Roth IRA owner after his death,
- attributable to the Roth IRA owner being disabled, or
- for certain qualifying first-time home purchases (up to \$10,000).

The 5-tax-year period for qualified distributions is not recalculated when a Roth IRA owner dies. If the Roth IRA owner contributes to a Roth IRA in 2001 and dies in 2006, a distribution made to his beneficiary in 2006 will be an untaxed distribution.

Normally, the 5-year period for the beneficiary's inherited Roth IRA is determined independently of the 5-year period for any other Roth IRA of which the beneficiary is the owner. However, if the beneficiary of the Roth IRA is the Roth owner's surviving spouse who also owns his or her own Roth IRA, the 5-year period for both the Roth IRA of which the surviving spouse is the beneficiary and the Roth IRA which surviving spouse owns ends with the earlier of the 5-year periods for the two Roth IRAs.

Minimum Required Distributions:

Unlike the traditional IRA, which requires the taxpayer to begin to take distributions at age 70 1/2, the Roth IRA has no such requirement. In fact, a taxpayer never needs to take a distribution from a Roth IRA. The taxpayer can continue to benefit from tax-free compounding of earnings for her entire life. If the beneficiary is the taxpayer's spouse, he can roll over the taxpayer's Roth IRA into his own Roth IRA and continue tax-free compounding for the rest of his life. Distributions must begin after the death of the taxpayer's spouse. However, if your spouse's beneficiary is a child, minimum distributions can be spread over that child's life. If the child is young, these distributions can be quite small adding little to the child's taxable income.

F. SPOUSAL IRAs.

A taxpayer with a spouse who does not have taxable compensation may set up a "spousal IRA." This lets the taxpayer set up two IRAs with a total contribution limit of \$4,000. No one may contribute more than \$2,000 to an IRA.

Before 1998, if one spouse was an active participant in a retirement plan (i.e., service member), both spouses were subject to the dollar limitations for the deductibility of IRA contributions. Now, even if a spouse is an active participant in a retirement plan (i.e., service member), the non-active participant spouse may be able to deduct a contribution to an IRA with higher phase out limitations (phase out begins at MAGI of \$150,000).

G. NONDEDUCTIBLE CONTRIBUTIONS.

Although the deduction for IRA contributions may be reduced or eliminated for some taxpayers, many may still make contributions of up to \$2,000 or 100% of compensation, whichever is less. They just may not be able to deduct all of the contributions. Anyway, the earnings on contributions (regardless of whether they are deductible or nondeductible contributions) will not be taxed until they are withdrawn from the account.

When distributions are later made from the IRA, special rules apply to the tax on the distributions if both deductible and nondeductible contributions had been made to the IRA.

An individual does not have to designate a contribution as deductible or nondeductible until the tax return is filed. Nondeductible IRA contributions are reported on Form 8606. All IRA contributions will be treated as deductible if nondeductible IRA contributions are not reported. The full amount of withdrawals from the IRA will be taxed unless it can be shown, with satisfactory evidence, that nondeductible contributions were made.

Those who overstate the amount of nondeductible contributions on Form 8606 for any tax year must pay a penalty of \$100 for each overstatement, unless it was due to reasonable cause. Taxpayers should maintain records to show the total nondeductible contributions.

H. TAX ON EXCESS CONTRIBUTIONS.

If a taxpayer's IRA contributions for the tax year exceed the maximum allowable amount for that year, the taxpayer will have to pay a 6% excise tax on the excess contribution (each year it remains in the IRA), unless it is withdrawn by the due date of his return.

Even if the contribution is withdrawn and tax is not due on the excess contribution, the taxpayer must withdraw and include the earnings on any excess contributions in gross income for the year the excess contributions occur.

I. TAX ON EARLY WITHDRAWALS.

Generally, taxable amounts a person withdraws from his IRA account before reaching age 59 1/2 are subject to an additional 10% tax. The 10% tax is beyond any income tax due on the distributions.

The 10% tax will not apply to the following distributions:

- 1) Portions of any distributions treated as a return of nondeductible contributions.
- 2) Distributions made after the person's death.
- 3) Distributions made because the person becomes disabled.

The 10% penalty also does not apply if withdrawals are made on a schedule based on the taxpayer's projected actuarial lifetime.

J. SHOULD YOU MAKE AN IRA CONTRIBUTION?

Many soldiers who have no income other than their military salary will still be able to make a fully deductible IRA contribution. Because the IRA phase-out rules are based on adjusted gross income, which does not include quarters and subsistence allowances, soldiers are allowed a fully deductible IRA contribution at actual salary levels above other taxpayers. Additionally, making contributions to IRAs can still produce tax savings for many high-income taxpayers because the earnings generated by IRA investments are tax-deferred.

Consult IRS Publication 590, Individual Retirement Arrangements, for more information.

**2001
TAX
INFORMATION
SERIES**

**MORTGAGE
INTEREST
DEDUCTION**

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**LEGAL ASSISTANCE TELEPHONE
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MORTGAGE INTEREST DEDUCTION LIMITS

Home mortgage interest is deductible by soldiers even if they are receiving tax-free Basic Allowance for Quarters. The law, however, may limit the amount of the deduction that may be claimed.

Under current law, home mortgage interest includes two categories of interest--interest on acquisition indebtedness and interest on home equity indebtedness.

Acquisition indebtedness is debt incurred in acquiring, constructing, or substantially improving the principal or second residence of the taxpayer. A taxpayer may also be allowed to refinance a home and substitute the new debt as acquisition indebtedness. The new debt qualifies as acquisition indebtedness, however, only to the extent it doesn't exceed the balance of the old debt. Debts incurred to substantially improve a residence are also treated as acquisition indebtedness. The total allowable acquisition indebtedness for any period cannot exceed \$1 million.

Home equity indebtedness also produces deductible mortgage interest. Home equity indebtedness is debt (other than acquisition indebtedness) secured by the home to the extent that the total amount of the debt doesn't exceed the fair market value of the home reduced by the amount of acquisition indebtedness. Thus, the combined total of acquisition indebtedness and home equity indebtedness cannot exceed the fair market value of the home total for two residences. Interest on home equity indebtedness is deductible even if the proceeds are used for purely personal purposes.

The total amount of home equity indebtedness cannot exceed \$100,000. The total amount of home equity indebtedness and acquisition indebtedness on both the principal residence and a second home cannot exceed \$1,100,000.

If the amount of acquisition indebtedness and home equity indebtedness is below the limits, all mortgage interest paid during the tax year is deductible provided the taxpayers itemize on their returns.

A qualified principal residence is the taxpayer's main residence. This can include a house, cooperative apartment, condominium, house trailer, or houseboat. A qualified second residence may include an unused residence if not rented, a residence that is used part of the year, or a rented residence. If the residence is rented out, it is subject to the use requirements relating to vacation homes (must be used for at least 14 days or 10% of the rental period, whichever is greater).

You should not overlook the three basic requirements for a home mortgage debt to be considered secured. First, the security instrument must make the debtor's interest in the residence specific security for the payment of the debt. Second, upon default, the residence must be subject to satisfaction of the debt with the same priority as a mortgage or deed of trust. Finally, the security instrument must be recorded or otherwise perfected under state law.

For more information, refer to IRS Publication 17, Your Federal Income Tax, or IRS Publication 936, Limits on Home Mortgage Interest Deduction.

**2001
TAX
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SERIES**

**DEDUCTIBILITY
OF POINTS**

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THE DEDUCTIBILITY OF "POINTS"
INCIDENT TO A SALE, PURCHASE, REFINANCING,
OR LEASE OF A HOME

A. POINTS.

The term "points" is sometimes used to describe certain charges paid by a borrower. They are also called loan origination fees, maximum loan charges, or premium charges. If the payment of any of these charges is only for the use of money, it is interest. A loan processing fee paid by the borrower as a bonus to get a conventional loan is deductible as interest. However, loan origination fees paid as a charge for services rendered in connection with a loan (such as a VA funding fee) are not considered interest.

Points paid for the use of money are interest paid in advance and generally are not deductible in full in the year paid. As a general rule, the prepaid interest must be spread over the life of the mortgage, and deducted ratably over the period of the loan.

Taxpayers may deduct the amount paid as points in the year of payment if the loan is used to buy or improve the taxpayer's main home and the loan is secured by that home. This exception applies only if--

- 1) The payment of points is an established business practice in the area where the loan was made;
- 2) The points paid did not exceed the number of points generally charged in the area; and
- 3) The points are paid directly by the taxpayer.

If a taxpayer paid more points than generally paid in the area, the taxpayer's deduction is limited to the points generally charged. Any additional amount of points the taxpayer paid must be spread over the life of the mortgage.

EXAMPLE

Lieutenant Don Smith borrowed \$48,000 to buy his \$60,000 home. He paid the lender, in addition to interest at 8%, a loan processing fee of \$1,440 (three points). None of the fee was for specific services. The charging of points was an established business practice in the area and the number of points was not more than that generally charged in the area. The \$1,440 loan processing fee (points) is interest. Don may deduct it in the year of payment.

EXAMPLE

Major Jan Green got a loan from a bank to buy her home. The loan was guaranteed by the Department of Veterans Affairs. Jan paid the bank a loan origination fee. The fee was 1% of the amount of the loan. It was charged in addition to the rate of interest permitted on VA loans. The 1% loan origination fee (one point) is now treated as interest. Jan may deduct it on Schedule A. (This result is effective for homes purchased on or after 1 January 1991.)

B. POINTS PAID BY THE SELLER.

The term "points" also is used to describe loan placement fees that the seller may have to pay to the lender to arrange financing for the buyer. The seller may not deduct these amounts as interest. But these charges are a selling expense reducing the amount realized. Buyers may now deduct seller-paid points on homes purchased on or after 1 January 1990. When the buyer deducts the seller-paid points, the buyer must reduce the basis of the home by the amount of the deduction.

C. REFINANCING.

Points a taxpayer pays in refinancing a mortgage, regardless of how he arranged to pay them, are not deductible in full in the year paid except to the extent they are paid in connection with the improvement of a home. This is true even if the new mortgage is secured by the taxpayer's principal residence. Annually, the taxpayer will deduct the ratable amount of interest from the points over the life of the loan.

If the taxpayer used part of the refinanced mortgage proceeds to make an improvement on his principal home and paid the points out of private funds (rather than out of the proceeds of the new loan), the taxpayer may apportion the points attributable to the amount of the proceeds used for the improvement and deduct the apportioned amount in full in the year paid. The taxpayer may also deduct the ratable portion of the amount of the points attributable to the new debt over the life of the loan.

EXAMPLE

In 1981, Captain Bill Fields obtained a mortgage for the purchase of a personal residence. The interest rate on that mortgage loan was 16%. Earlier this year, Bill refinanced this mortgage with a 15-year \$100,000 mortgage loan that has an interest rate of 10%. To obtain financing, Captain Fields paid three points (\$3,000). Bill paid the points out of his private funds. The payment of points is an established practice and the points charged do not exceed the amount generally charged in the area. Bill made six payments on the loan this year. Bill is a cash basis taxpayer.

Bill Fields used the funds obtained from the new mortgage to repay his existing indebtedness. Although the new mortgage loan was incurred in connection with Captain Fields' continued ownership of his principal residence, the new mortgage was not incurred in connection with the improvement of that residence. Therefore, Bill cannot deduct all of the points this tax year. So long as the loan origination fee is classified as points on the settlement statement, he can deduct the total of three points ratably over the life of the loan.

EXAMPLE

Assume the above facts, except that Captain Fields used \$25,000 of the loan proceeds to make an improvement to his principal home. Because he paid the points in 199X, he is allowed to deduct, in 199X, 25% (\$25,000 divided by \$100,000) of the three points that represent prepaid interest. His deduction for the portion of the prepaid interest that is attributable to his home improvement is \$750 (\$3,000 prepaid interest X 25%). Additionally, in 199X, Bill can deduct the ratable portion of the \$2,250 (\$3,000 prepaid interest - \$750 attributable to home improvement) that must be spread over the life of the loan. He can deduct \$75 of the ratable portion of the prepaid interest in 199X (\$2,250 ratable portion of prepaid interest divided by 180 months (life of the loan) X 6 payments made in 199X = \$75). The total amount deductible in 199X is \$825 (\$750 + \$75). If Bill makes all of his payments when due, his annual deduction will be \$150 each year for 199X through 2006 (\$2,250 divided by 180 months X 12 payments = \$150). His deduction in 2007, the final year of payment, will be \$75 because he will make six payments that year.

EXAMPLE

Assume the same facts from the examples above, except that Bill did not pay the points out of his private funds. Rather, the bank deducted the points from the loan proceeds. Since Bill did not actually pay the points, he cannot apportion the three points which are prepaid interest to the portion of the loan used to make home improvements. Captain Fields must spread the three points (\$3,000) ratably over the life of the loan.

**2001
TAX
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**TAXATION OF
GAIN ON SALE OF
PRINCIPAL
RESIDENCE**

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TAXATION OF GAIN ON THE SALE OF PRINCIPAL RESIDENCE

The Taxpayer Relief Act of 1997 significantly modified section 121 of the Internal Revenue Code. For home sales after 6 May 1997, a single taxpayer may exclude up to \$250,000 of gain from the sale of a home. Married couples who file jointly may exclude up to \$500,000 of gain. To qualify for the exclusion, the taxpayer must have both owned and used the property as a principal residence for 2 years or more during the 5-year period ending on the date of sale.

The modifications to section 121 repealed section 1034 -- the "roll over" rules. These rules allowed homeowners to defer the gain from the sale of a "principal residence" by purchasing a new home of equal or greater value. Determination of "principal residence" was based on facts and circumstances. To qualify, it must have been the taxpayer's "principal residence" at the time of sale.

Given the proper facts, case law applying the "roll over" rules allowed a homeowner to be absent from his or her principal residence for an extended period without it losing its status as the principal residence. Additionally, the roll over rules gave military homeowners as many as 8 years after the sale to purchase a new residence (complete the roll over) to defer tax on any gain.

Under the new law, for houses sold after 6 May 1997, a military member must actually "own and use" the property for 2 years of the 5-year period immediately preceding the sale to qualify the property for the complete exclusion. This test is strictly applied. The "facts and circumstances" test is no longer used.

Military homeowners are often assigned away from the home they consider to be their principal residence. Many military members have been absent from their homes for extended periods assuming they could "roll over" any gain upon sale. For sales after 6 May 1997, this is no longer true. Those who have been absent from their homes for periods greater than three years and sell after 6 May 1997, will fail the strict time requirement of the "owned and used" test. Upon sale of the property, the military member may be subject to tax on part or all of the gain.

Sales on or before 6 May 1997, still are controlled by the "roll over" rules. The military homeowner has 4 years (up to 8 years if stationed overseas) to complete the roll over and defer the gain from the sale. However, if the homeowner fails to timely complete the rollover, the gain from the sale will be taxed.

Current state of the Law: Read and interpret IRC § 121 literally. If the taxpayer has not owned and used the home for 2 of the 5 years immediately preceding the date of sale, he will not qualify for the full exclusion. No special relief provisions exist for the members of the Armed Forces or absences from the home due to military service. Recent efforts to enact such legislation were unsuccessful. The Armed Forces Tax Counsel will continue to pursue relief for the military homeowner.

If you sold your principal residence prior to 7 May 1997, tax on part or all of the gain from the sale of your principal home (residence) may be postponed. If you buy a replacement home, and the purchase price of the replacement home is at least as much as the adjusted sales price of the old home, you may be able to postpone paying the tax on all the gain from the sale. If you do not buy a replacement home, or if the purchase price of the replacement home is less than the adjusted sales price of the old home, you will be subject to tax on some or all of the gain, unless you qualify to exclude the gain as explained later.

You must physically live in the replacement home as your principal home within the required period. If you move furniture or other personal belongings into the new home but do not actually live in it, you have not met the occupancy test.

If you do not replace the home in time, you must file an amended tax return for the year of sale and report the entire gain on the sale of your old home. Additionally, you will be required to pay interest on the amount of tax that was due in the year of the sale but was not paid. If you began building your new home within the specified period, but for any reason were unable to live in it within the replacement period, you do not have any more time for occupancy and must report your entire gain on an amended return for the year of sale.

Members of the Armed Forces. The replacement period for most taxpayers begins two years before the date of sale and ends two years after the sale. The replacement period after the sale of your old home, however, is suspended while you serve on extended active duty in the armed forces. You are on extended active duty if you are serving under a call or order for an indefinite period or for more than 90 days. The suspension applies only if your service begins before the end of the 2-year replacement period. This time in which to reinvest, including any period of suspension, is generally limited to four years from sale of your old home, unless you qualify for additional time as explained below.

The replacement period is also suspended while you are stationed outside the United States for up to eight years. Following your return from a tour of duty outside the United States, the replacement period will be suspended if you are required to live on base because you are stationed at a remote site where the Secretary of Defense has determined that adequate off-base housing is not available. In either case, the replacement period will not expire until one year after the last day you are assigned overseas or are required to live in government quarters following overseas assignment. The replacement period, plus any period of suspension, is limited to eight years from the date of sale of your old home.

If your spouse is in the armed forces and you are not, the suspension applies to you if you own the old home. Both of you must have used the old home and the new home as your principal home. If you are divorced or separated while the replacement period is suspended, however, the suspension ends for you on the day after the date of the divorce or the date that you physically separate from your service member spouse. Normal temporary separations caused by duty assignment, however, do not end the suspension.

A taxpayer who has already filed an income tax return reporting gain from the sale of a home, but purchases and lives in a new home within the replacement period, with extensions, may file form 1040X, Amended U.S. Individual Income Tax Return, to claim a refund. This can only be done, however, for tax years not closed by the statute of limitations (generally three years after the filing deadline).

Principal Home: Usually, the home in which you live is your principal home (residence). The home that you sell and the one you buy to replace it must both qualify as your principal home. A houseboat or mobile home may be your principal home. A condominium home or apartment may also be your principal home. Your basis in the apartment is usually the cost of your stock in the co-op housing corporation, which may include your share of a mortgage on the apartment building. Furniture, appliances, and similar items that are not fixtures (permanent parts of the property) generally are not part of your principal home.

If you have more than one home, only the sale of your principal home qualifies for postponing the tax. For example, you own and live in a house in town and also own beach property, which you use in the summer months. The town property is your principal home; the beach property is not.

If you have two homes and live in both of them, your principal home is the one you live in most of the time. If you own a house, but live in another house for which you pay rent, the rented home is generally your principal home.

Whether or not property is used by you as your principal home (residence) depends on all the facts and circumstances, including your good faith. Even if you temporarily rent out either your old home or your new home, you may still be able to postpone the tax from the sale of the old home. Also, there is no requirement that you must actually be living in your old home at the time of its sale.

Generally, the cases in which taxpayers have been allowed to postpone the tax on gain from the sale of their old home when they were not living in the house but were renting the house at the time of sale involve either the temporary rental of a residence to which the taxpayer intended to return, or, situations involving extended rental of the property where economic circumstances precluded the sale, or other exceptional or unusual facts and circumstances over which the taxpayer had no control.

The IRS generally asserts that if you temporarily rent out your old home before selling it (or your new home before living in it) you will be able to postpone the tax on the sale of the old home only if such temporary renting out was done as a matter of convenience, or for another nonbusiness purpose.

If you rent your home, and none of the theories are available for you to claim that it retains a principal residence status, it will likely be considered as converted to property held for the production of income. If your old home qualifies as converted to rental property, that is, being held by you for the production of rental income, you may take rental expense deductions for the property, including depreciation. You may not, however, be permitted to postpone the tax on the sale of your old home. Also, if you place your old home with a real estate agent for rent or sale, and it is not rented, it will not necessarily be considered business property or property held for the production of income. Thus, the IRS looks to the use of your old home at the time of its sale to determine whether you can postpone the tax from the sale.

A recent case has held, however, that a former home can qualify for the postponement of tax on its sale even if the home was temporarily rented and was held for the production of income. Thus, the taxpayers were able to not only postpone the tax, but also to take depreciation deductions and deductions for rental expenses (insurance and miscellaneous maintenance expenses) against the income from the rental of their old home.

For more information, see IRS Publication 523, [Selling Your Home](#).

**2001
TAX
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**TAX TREATMENT
OF RENTAL
PROPERTY**

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TAX TREATMENT OF RENTAL PROPERTY

The Taxpayer Relief Act of 1997 provides that you can exclude the gain on the sale of a home so long as the home is sold after 6 May 1997 and the taxpayer lived in the home for two of the past five years. The maximum amount of gain that can be excluded is \$250,000, if single and \$500,000, if married filing a joint return. If a taxpayer lived in the home for less than the full two years during the last five years, he can exclude a pro rata share of the allowable exclusion. For example, if a taxpayer lived in a home for one year during the previous five years, he can exclude one-half of the allowable gain, which is \$125,000, if single, or \$250,000, if married filing a joint return.

For the investor in residential housing, there are four major provisions to consider: (1) depreciation allowances, (2) the rental loss limitation, (3) the tax rate schedule, and (4) the tax treatment of capital gains.

FINANCIAL OPERATIONS OF RENTAL PROPERTY.

In preparing the annual individual tax return, rental income is totaled for the year, and the expenses associated with the rental operations (for example, depreciation, repairs, insurance, mortgage interest, and property taxes) are deducted to determine the taxable income or loss. Depreciation is a particularly important expense. Each year a percentage of the building's value (but not the land) is taken as an expense to compensate for wear and tear and obsolescence, although this is not an amount that is actually paid "out of pocket."

DEPRECIATION.

Those taxpayers purchasing residential investment property after 1986 are only eligible for straight-line depreciation over a 27.5-year period compared to the more rapid 19-year, 175-percent declining balance method available under prior law. Those currently owning rental property must generally keep using the depreciation schedule they began with.

RENTAL LOSS LIMITATION.

Under the current law, losses from rental property are considered as "passive investment" losses. Losses on passive investments can generally only be used to affect income from passive investments. Accordingly, owners can deduct rental losses only against other rental property income or other passive investment income. Rental losses cannot be deducted against salary, dividends, and interest income. Losses that cannot be deducted currently because of these rules may be carried forward indefinitely to future years and may be used to offset future passive income. Additionally, in the year the property is sold, past, unused losses can be used to offset gain on the sale.

There is an important exception for the small investor, however. Taxpayers with adjusted gross income of \$100,000 or less may be eligible to deduct up to \$25,000 of passive

losses a year against salary and portfolio (investment) income. This maximum of \$25,000 of annual losses is reduced or phased out, however, over an income range of \$100,000 to \$150,000.

The available deduction is reduced \$1 for each \$2 of adjusted gross income above \$100,000. To be eligible for this small-investor exception, the investor has to "actively participate" in the management of the property. Property management services can still be used if the owner remains involved in decision making, such as approving tenants, setting rent levels, approving terms of the lease, and approving major expenditures and repairs. At least a 10-percent ownership in the property is also required.

Regardless of when the property was purchased, rental losses that cannot be taken in a given year can be carried forward for use in later years and any remaining loss can be taken in full when the property is sold.

Investors with annual rental losses first use the losses to offset any rental income. Any remaining losses are then applied to offset up to \$25,000 of other income for taxpayers who "actively participate" in the management of the property. Any remaining losses are carried forward for use in future years.

MORE INFORMATION.

For more information on rental property, consult one or more of the following IRS publications:

Pub. 527, Residential Rental Property

Pub. 534, Depreciation

Pub. 544, Sales and Other Dispositions of Assets

Pub. 925, Passive Activity and At-Risk Rules

Pub. 17, Your Federal Income Tax

**2001
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**SERVICES
PERFORMED FOR
CHARITIES**

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SERVICES PERFORMED FOR CHARITIES

Many soldiers and their family members donate their time and services in support of bona fide charitable organizations such as churches, boy scouts, and others. Although admirable, they may not take a charitable deduction for the value of their time or services.

The Tax Court has upheld regulations disallowing a charitable contribution deduction for the value of contributed services. In one case, the taxpayer performed uncompensated legal services for organizations eligible to receive deductible charitable contributions. The taxpayer did not include the value of these services as income. On his income tax returns, he deducted amounts representing the value of the time he spent performing the services. When he prepared his returns, he was aware that Treas. Reg. § 1.170A-1(g) prohibited a charitable contribution deduction for a contribution of services, but he deliberately disregarded the regulation because he believed that it was invalid.

The Tax Court held that the taxpayer was not entitled to deduct the value of his contributed services to the charitable organizations under IRC § 170. The court also determined that regulation § 1.170A-1(g), which disallows the deduction of the value of contributed services, is valid. Additionally, the court held that the taxpayer had no reasonable basis in claiming a charitable contribution deduction for the value of his contributed service and was, therefore, liable for an addition to tax for intentional disregard of the regulations.

While it is well established that a taxpayer may not deduct the value of his time or services contributed to charity, he may deduct the fair market value of any gift to charity and the amount of any reasonable expenses incurred in performing charitable services. For example, if the taxpayer incurs transportation expenses in service of a charitable organization, those expenses are deductible. Taxpayers may deduct the actual cost of the transportation, or a flat mileage rate of \$0.14 per mile driven. Deductible expenses include parking fees, tolls, and mileage to and from the location of the charitable service. As with any deduction, however, the taxpayer must keep adequate records of those expenses to deduct them.

While expenses incurred by those donating their services to charity are generally deductible, they are only deductible as itemized deductions on Schedule A of Form 1040. Moreover, the deduction is subject to the 3% reduction of total itemized deductions if the taxpayer's adjusted gross income exceeds \$132,950 (\$66,475 if married filing separately).

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SERIES**

**TAX COLLECTION
PROCESS**

This pamphlet provides information concerning your federal income taxes. If you have legal questions concerning your taxes, and your unit tax advisor is unable to answer them, call the number below for an appointment to see a lawyer.

**LEGAL ASSISTANCE TELEPHONE
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OFFICE OF THE STAFF JUDGE ADVOCATE

TAX COLLECTION PROCESS

When a taxpayer fails to pay the full amount of federal tax owed, the Internal Revenue Service (IRS) will collect the delinquent tax in one of several ways. The following questions and answers should help explain the process:

Q: I thought I had paid my taxes and now I have received a notice from the IRS saying I owe more. How can that be?

A: There may be several reasons. You may not have had enough tax withheld from each paycheck or perhaps an error occurred in the preparation of your return. If you are self-employed or had other income not subject to withholding, you may have missed making the required quarterly estimated tax payments.

Q: The IRS says I owe more tax, but I do not agree. What can I do?

A: If you think the bill is wrong, notify the IRS immediately by writing to the office that sent the bill. You may want to send copies of any record that support your claim, such as canceled checks or tax returns. Do not send the originals to the IRS!

Q: Do I have to pay the entire amount of delinquent taxes immediately?

A: If possible. The employee handling your collection case will review financial information that you provide to the IRS and determine whether the full amount can be paid at once, or if you qualify for an installment payment plan.

Q: What if I do not pay the IRS after they notify me that I owe delinquent taxes?

A: When an individual owes more tax, a bill is sent with payment due within 10 days. Several more bills and a telephone call may also follow. If a taxpayer neglects or refuses to pay taxes or to make satisfactory arrangements for payment, a levy may be issued against the taxpayer's salary, wages, bank accounts, or

commissions. During the levy process, if the tax bill is paid in full or an acceptable installment agreement is reached, ordinarily the levy will be released.

Q: What rights do I have during collection proceedings?

A: Taxpayers have several basic rights during all collection-related activities. They include representation, the transfer of a tax case to another office when your residence changes, receipts from the IRS for any payment, copies of all contractual arrangements, confidentiality of tax matters, and elimination of penalty with reasonable cause.

Q: I received a bill from the IRS for some additional tax and paid the amount in full. However, after going over my records, I found some documents to verify that I owe less tax. What can I do?

A: If your records now show that you overpaid your tax, you should file an amended return on Form 1040X, Amended U.S. Individual Income Tax Return.

Q: Where can I get more detailed information about the collection process?

A: More information is available in IRS Publication 586A, The Collection Process (Income Tax Accounts); IRS Publication 1, Your Rights as a Taxpayer; and IRS Publication 556, Examination of Returns, Appeal Rights, and Claims for Refund. These are all available free by using the mail-order form in your tax package or by calling the IRS at its toll-free number for ordering forms.

Visit your local Legal Assistance Office if you have additional questions on personal income tax matters.

**2001
TAX
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**EMPLOYEE
BUSINESS
EXPENSES**

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EMPLOYEE BUSINESS EXPENSES

EXCESS EXPENSES DEDUCTED AS ITEMIZED DEDUCTIONS.

To be deductible, travel expenses must qualify as ordinary and necessary expenses incurred while traveling away from home overnight. Such expenses include air fares, the costs of operating and maintaining a car, and the cost of meals and lodging. Transportation expenses are the expenses of getting from one work place to another while not traveling away from home. Such expenses include the costs of operating and maintaining a car, but not meals and lodging. Commuting expenses for traveling to and from home to work are not deductible.

Employees, including outside salespersons, may deduct only the amount of work-related business expenses not reimbursed by the employer. Any expenses incurred by the employee in excess of the amount reimbursed by the employer are deductible only as a miscellaneous itemized deduction on Schedule A (Form 1040).

Except for those cases where an adequate accounting is made to the employer and the business expenses are equal to the reimbursements, Form 2106 must be completed and attached to the Form 1040 if a deduction is claimed for any employee business expenses. This applies to reimbursed expenses claimed as an adjustment to income and to unreimbursed expenses claimed as a miscellaneous itemized deduction on Schedule A (Form 1040). Additionally, these expenses are allowable only to the extent that miscellaneous itemized deductions

cumulatively exceed 2% of Adjusted Gross Income.

The employee must itemize deductions to claim unreimbursed employee business expenses. In addition, there is a 50% limit on deductions for business meals (including meals while on travel) and entertainment expenses which must be figured before applying the 2% limit.

Where reimbursements equal or exceed expenses. If an employee's allowances and reimbursements are equal to, or exceed, he business expenses and no accounting is made to the employer, the employee must attach Form 2106 to the Form 1040. In such a case, use Form 2106 to detail the amount of the expenses and the reimbursements. If the employer includes the reimbursement on the employee's Form W-2, or a Form 1099, the employee must include this amount with his wages, salary, or other income shown on Form 1040 and must also show the reimbursement and business expenses on Form 2106.

Special rule if employees account to employer for business expenses. Reimbursement arrangements, per diem, and mileage allowances (such as military personnel receive while on TDY) qualify as adequate accounting of employee expenses. Under special rules, these employees generally need not report expenses if reimbursements do not exceed expenses.

Where expenses are unreimbursed or exceed reimbursements. If an employee's business expenses are either unreimbursed, or exceed the employer's reimbursement, the employee must use Form 2106 to figure the amount of unreimbursed business expenses that must be entered on Schedule A (Form 1040) and claimed as a miscellaneous itemized deduction (provided the employee itemizes his deductions). If the employee received any amount of reimbursement or allowances for business expenses, Form 2106 must also be used to detail the amount of expenses covered by the reimbursements that are claimed as an adjustment to income.

MEALS AND ENTERTAINMENT EXPENSES.

Deductions for business meals and entertainment expenses are limited to 50% for such expenses. Meal expenses are deductible only if the expenses are directly related to or associated with the active conduct of a trade or business. The deductible amount for entertainment tickets, sky boxes, or other private luxury boxes is limited.

In addition, an employee, including an outside salesperson, may deduct unreimbursed business expenses, including meals and entertainment expenses, only as a miscellaneous itemized deduction.

The 50% limit. A taxpayer may deduct only 50% of business-related meal and entertainment expenses, including meals incurred while traveling away from home on business. The 50% limit, however, does not apply to an employee for any business related meal and entertainment expenses that were, however, reimbursed by the employer.

In this situation, the employer is subject to the 50% limit.

Meal and beverage expenses. Taxpayers may not deduct meal and beverage expenses unless they establish that the expenses were directly related to the active conduct of their trade or business, or, in the case of an expense directly preceding or following a substantial and bona fide business discussion, that the expense was associated with the active conduct of their trade or business.

Meal and beverage expenses are not deductible unless business is discussed during, or directly before or after, the meal (except when the taxpayer is traveling away from home on business and claims a deduction for his meal only).

Additional restrictions. Meal and beverage expenses, whether or not incurred while the taxpayer is on business travel, are not deductible to the extent they are lavish or extravagant under the circumstances. In addition, no deduction for meal and beverage expenses is allowed unless the taxpayer (or his employee) is present at the furnishing of the meal.

Entertainment Expenses. As under previous law, taxpayers may be able to deduct ordinary and necessary entertainment expenses if they establish that the expenses were directly related to the active conduct of their trade or business. In the case of an expense directly preceding or following a substantial and bona fide business related activity, taxpayers must establish that the expense was associated with the active conduct of their trade or business.

The 50% limit also applies to entertainment expenses. In addition, the amount that may be deducted for entertainment tickets, sky boxes, or other private luxury boxes is limited.

TRAVEL EXPENSES.

The code limits the amount of deductions for costs of cruise ship or other luxury water transportation and eliminates the deduction allowed for educational travel expenses. It also limits the deduction for transportation and other travel expenses while a taxpayer is away from home for a charitable organization. It eliminates the deduction allowed for travel or other costs of attending conventions or seminars for investment purposes.

Luxury water transportation. The amount of deductions allowed for travel expenses by cruise ship or other luxury water transportation is limited to twice the highest per diem generally available to employees of the federal government for travel in the United States, times the number of days in transit.

The per diem limit does not apply to the expenses of attending a convention, seminar, or similar meeting held on a cruise ship. If the taxpayer establishes that the meeting is directly related to his trade or business, and certain other requirements are met, he may deduct up to \$2,000 of these expenses.

Educational travel. Taxpayers cannot deduct the cost of travel that in itself is a form of education.

Charitable travel expenses. Charitable deductions for transportation and other

travel expenses while away from home, including amounts spent for meals and lodging, are allowed only if there is no significant element of personal pleasure, recreation, or vacation in such travel.

Convention expenses. No deduction is allowed for travel or other costs of attending a convention, seminar, or similar meeting unless the activity relates to taxpayer's trade or business. For example, expenses for registration fees, travel and transportation costs, meals and lodging expenses, etc., incurred in connection with attending an investment seminar or other activity not related to the taxpayer's trade or business are not deductible.

In addition, no deduction will be allowed for expenses of attending a trade- or business-connected convention, seminar, or similar meeting that does not offer significant business-related activities, such as participation in meetings, workshops, lectures, or exhibits held during the day. Thus, the cost of attending a seminar would not be deductible if participants are merely furnished video-tapes of business-related lectures to be viewed at their own convenience.

Consult IRS Publication 535, Business Expenses, for more information.

BUSINESS USE OF HOME.

Consult IRS Publication 587, Business Use of Your Home.

**2001
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**TAX ASPECTS OF
DIVORCE**

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TAX ASPECTS OF DIVORCE

A. IN GENERAL. Divorcing taxpayers should understand the tax consequences of the divorce settlement. The major areas of concern are:

1. Alimony. Qualifying alimony payments are deductible by the person making the payments (the payor) and are included in the income of the person receiving the payments (the recipient).

2. Child Support. Payments which are specifically fixed in the divorce or separation agreement as child support are not deductible by the payor and are not considered income to the payee.

3. Division of Property. Most transfers of property between spouses after July 18, 1984, may be made tax free. However, the recipient of the property will be subject to a capital gains tax on the subsequent disposition of most property.

B. ALIMONY. Payments made to a spouse before there is a qualifying instrument (i.e., a separation agreement or court decree) are not deductible as alimony. Payments made pursuant to a divorce or separation instrument will be deductible as alimony if each of the following requirements are met:

1. The payor and the recipient do not file a joint income tax return;
2. The payments are made according to the terms of an existing divorce or separation instrument which requires the payments as alimony or spousal support, and not as child support;
3. The payments are made in cash, check, or money order;
4. The payments will terminate on the death of the recipient;
5. If the parties involved are divorced or legally separated, they must live in separate households when the payments are made;
6. Generally, the payments do not decrease by more than \$15,000 from one calendar year to the next. If they do, certain recapture rules may apply. This requirement applies to divorce or support decrees and agreements executed after 1986; and
7. Both the payor and the recipient do not make an election to avoid treating the payments as alimony.

Alimony is reported as income or claimed as an adjustment only on Form 1040.

C. CHILD SUPPORT. Payments made to a former spouse for child support are not alimony. Thus, they are not deductible by the payor or income to the recipient. To be considered as child support, any one of the following circumstances must be applicable to payments made pursuant to divorce or separation instruments executed or modified after 1984:

1. If the divorce or separation instrument specifically designates an amount as child support;
2. If the instrument provides for a reduction in the amount of a spousal support payment on the happening of an event or contingency relating to a child, e.g., the reaching of a certain age by the child, or upon his marriage, in which case the amount of the reduction is treated as child support; or
3. If such instrument provides for a reduction in spousal support payments either within six months before or after a child reaches 18, 21, or other age of adulthood under state law, or if there are two or more children, if a reduction occurs at intervals within one year before or after a certain age is reached by each child between 18 and 24.

A taxpayer who is divorced may claim a dependency exemption for any of his children if:

1. The taxpayer and his spouse (i.e., parents of the child) together furnished over half of the child's support during the year;
2. The taxpayer, his former spouse, or the two of them together had custody for the child for more than half the year;
3. The parents are divorced, legally separated under a written separation agreement, or lived apart at all times during the last six months of the year; and
4. The taxpayer is the "custodial parent," i.e., he had physical custody of the child for a greater portion of the year than did the other parent.

The parent who does not have custody may not claim the dependency exemption for a child unless the parent who has custody waives his right to the exemption. Both parents may deduct medical expenses they paid on behalf of the child regardless of which parent gets the dependency exemption for the child.

D. DIVISION OF PROPERTY. If a taxpayer transfers property to his spouse incident to a divorce, the taxpayer does not recognize gain or loss on that transfer. This is true whether or not the taxpayer receives property in exchange for the transfer.

In addition, it does not matter whether the transfer happens before or after the divorce, if any post-divorce transfers are "incident to the divorce." A transfer is incident to the divorce under the following circumstances:

1. The transfer is made within one year after the marriage ends; or
2. The transfer is related to the ending of the marriage. This means that the transfer is made pursuant to a divorce or separation agreement and occurs within six years after the marriage has ended. (The six-year period may be extended under certain circumstances.)

The basis of the property received by the transferee is the same as the adjusted basis of the transferor immediately before the transfer.

Special rules apply to transfers of business property, retirement benefits, annuities, and life insurance.

See IRS Publication 504, Tax Information for Divorced or Separated Individuals, for more information.

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**FOREIGN EARNED
INCOME**

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FOREIGN EARNED INCOME

Introduction.

Taxpayers who are living and working overseas have the potential of taking advantage of a significant tax break--the Foreign Earned Income (FEI) exclusion. If you determine you were qualified in previous years but failed to take it, you should amend your prior years' tax returns by filing a Form 1040X and Form 2555 for the applicable year(s). You can amend your prior tax return back three years from the date you filed it or two years from the date you paid your tax, whichever is later. This tax guide explores the Foreign Earned Income exclusion and how it can be claimed.

You can exclude up to \$78,000 of your FEI from your total federal taxable income if you spent the entire tax year (1 January - 31 December) in a foreign country or countries. If you spent less than the entire tax year overseas, then this \$78,000 limit is lowered pro rata for each day you did not spend overseas.

What Foreign Earned Income Is and What It Isn't.

FEI is income "earned" from "foreign" sources. "Earned" includes salaries, wages, commissions, fees, bonuses, profits, royalties, and rents. It does not include pensions, annuities, interest, dividends, gambling winnings, or alimony (these items cannot be excluded--however, a foreign tax credit is normally allowed for foreign taxes paid on these forms of income). "Foreign" includes any source outside the United States, except sources from the United States Government or its agencies.

Foreign sources include overseas universities (e.g., University of Maryland); foreign corporations and businesses (including those doing business with the U.S. Government); overseas U.S. corporations and businesses; and nonpersonal services contracts through U.S. Government contracting offices, or independent contractors working for the U.S. Government. Nonforeign sources include the U.S. Government whether overseas or not; AAFES, nonappropriated fund, and MWR activities; DOD Dependent School System; or personal services contracts through U.S. Government contracting offices.

If you are an employee of the U.S. Government or one of its agencies, including nonappropriated fund instrumentalities (NAF), your income cannot be excluded. If you are not an employee, your income can be excluded. There are three interesting job situations raising the question whether there is FEI or not:

Child Care. As an example, your dependent spouse provides child care for other Americans in your housing area. Is the money he earns FEI, although all of the clients are Americans? Yes, it is. This is an example of a personal services arrangement having no U.S. Government connections. You may exclude income from such transactions. Check with the local Legal Assistance Office for current information on how IRS treats subsidy income paid to child care providers.

Independent Contractors. Distinguish between employees of the U.S. Government and its agencies and independent contractors who work for the U.S. Government or one of its agencies, and who, effectively, are self-employed individuals. Independent contractors can view their compensation by or through the government as FEI. Here are three examples:

First, you teach a natural childbirth class through the auspices of the Recreation Center--though compensated by the Center, an agency of the U.S., in fact the Center acts only as a conduit. The Center collects student tuition, dispensing it to you after keeping a certain percentage to defray the Recreation Center's costs (and a certain amount of profit). You are an independent contractor.

Second, you work as an organist at the Base Chapel, compensated by some sort of chaplain or church fund. You too are probably an independent contractor, and not a genuine employee of the U.S. Government. Depending on the source of the funds being used to hire you, you may also be able to claim the FEI exclusion on the grounds that the source of your income is the parishioners instead of the government.

Third, the Education Center hires you to act as an education counselor on what is called a "nonpersonal services contract" through the Contracting Office. You too are an independent contractor who is earning FEI.

Note that whether you are an employee or a self-employed person depends on all the facts and circumstances of the case. However, if the U.S. Government or one of its agencies does not give you a W-2, but a Form 1099 MISC (Nonemployee Compensation) instead, you are probably self-employed for purposes of FEI. However, see the discussion about self-employment taxes below.

Paid by a Foreign Finance Office. In Germany, for example, German civilian employees of the U.S. Army are paid in Deutsche Mark by the Defense Costs Office, a German agency which dispenses funds provided it by the U.S. Government. If your spouse is employed in such a fashion and you decide to file a joint return, you would have to include such compensation. Although paid in a foreign currency by a foreign agency, for tax purposes it is clear the spouse is an employee of the U.S. Government or one of its agencies. The spouse may be a nonresident alien for tax purposes, however, and as such he would not have to file taxes at all, unless the couple wanted to file a joint return. If they filed a joint return, then they report this income. Even if this income is reportable, a Foreign Tax Credit could be taken for any foreign income taxes paid on this foreign income.

How To Qualify to Take the FEI Exclusion.

Besides having to have FEI in the first place, you must meet either a foreign residence test or a physical presence test to be eligible to take the FEI exclusion.

Foreign Residence Test. If by the due date of your tax return, you establish a true residence in a foreign country or countries for an uninterrupted period that includes the full year (1 Jan - 31 Dec), then you satisfy this test. You can prove your intent to make a foreign country your residence in a variety of ways, such as registering with local authorities as a resident, buying a home there, bringing your family with you, participating in community activities, etc. By doing this, you have not given up your American identity or your domicile in the U.S. Most military personnel, however, will find it easier to satisfy the physical presence test.

Physical Presence Test. As of the due date of your tax return, if you have been present in any foreign country or countries for 330 days out of any consecutive 12-month period, then you have satisfied this test. Any consecutive 12-month period will do. Time spent traveling between countries generally counts in the 330 days, as well as vacations spent in foreign lands. Any time spent in the U.S. cannot count.

Did You Fail Both Tests? If you failed both tests, there are at least two methods to allow you more time to satisfy them and still take the FEI exclusion.

First, you can ask for an extension to file your return. You would file a Form 4868 and receive an automatic two-month extension from 17 June 2002 until 15 August 2002. If you need more time, file a Form 2350 (not a Form 2688) and send it to the IRS Service Center, Philadelphia, Pennsylvania 19255. If you owe taxes, however, you owe them by 15 April 2002, and interest on the money owed will keep accruing at a compound rate until you pay the tax, despite any extensions.

Second, you can file your return as usual, obtaining no FEI exclusion, and then when you qualify, file an amended return, Form 1040X along with a Form 2555, to obtain the FEI exclusion.

How Do You Take the FEI Exclusion?

First, include all the FEI you received with all your other income at line 7 of the Form 1040 (you cannot use the 1040A or 1040EZ). Then fill out the Form 2555, Foreign Earned Income, to take the exclusion. After filling out the form, enter the result obtained as a negative number at line 21 of the Form 1040 (express this by putting the number in parenthesis). In the space provided at line 21, write: "Exclusion From Form 2555." As a result, you have effectively added in your FEI, and later, subtracted it back out.

As indicated before, most military and civilian employee taxpayers do not qualify to take their housing expenses, and do not qualify for the Foreign Residence Test. Therefore, Parts I, IV, and VII of Form 2555 are usually left blank.

FEI and Other Deductions and Exclusions. A confusing question asked about FEI is whether one can exclude it from one's taxable federal income, and still take a particular deduction, exclusion, or credit. Here are several more important tax savings devices you can, and cannot, take if you elect to exclude the FEI.

Business Expenses. If you exclude FEI, you cannot deduct employee business expenses attributable to earning the FEI (i.e., using the Form 2106 and Schedule A).

Individual Retirement Accounts. If you exclude FEI, you cannot use it in figuring how much of an IRA contribution you can make for the year. You may, however, elect to exclude only a part of your FEI, and use the rest for an IRA contribution. When determining your modified adjusted gross income (AGI) for purposes of figuring how much of your IRA contribution is deductible for 2001, do not reduce your AGI by your FEI.

Foreign Tax Credit. If you exclude FEI, you cannot take a Foreign Tax Credit for the foreign taxes attributable to the FEI. If you have "foreign income" which does not meet the requirements for FEI or is beyond the \$78,000 exclusion limit, this income is subject to both foreign and U.S. taxes; and U.S. tax law allows you a Foreign Tax Credit for the foreign taxes paid on this amount.

The spouse of a citizen who is a nonresident or a resident alien working in a local national position for the Army, and who is paid in Deutsche Mark by the Defense Costs Office is another example of how to take a foreign tax credit. Such a person would be paying foreign taxes on his income. As to the resident spouse, he would have to declare this income on his return (since it is not FEI), but could take a foreign tax credit for the foreign taxes paid on it.

The nonresident alien spouse has the option of reporting or not reporting this income (because of his status as a nonresident alien). If the nonresident alien chooses to file jointly with his citizen spouse, however, then this income would be reportable; and they could take a foreign tax credit. Take foreign tax credits using Form 1116.

Foreign Taxes Paid. Foreign taxes include income taxes, excess profit taxes, and similar taxes by a foreign country in the form of an income tax. It also includes taxes on dividends and interest. You cannot take a credit or deduction for foreign income taxes paid on income that is exempt from tax under the FEI exclusion, the foreign housing exclusion, or the possession exclusion. If your wages are completely excluded, you cannot deduct or take a credit for any of the foreign taxes paid on those wages. If only part of your wages are excluded, you cannot deduct or take a credit for the foreign income taxes allocable to the excluded part. Generally, you can take foreign income taxes paid on included income as a foreign tax credit using Form 1116 or as an itemized deduction on Schedule A. As for foreign real estate taxes however, these

can be deducted using Schedule A (or Schedule E for foreign rentals)--these are not considered foreign taxes for the purposes of the Foreign Tax Credit.

Earned Income Credit. If you take the FEI, you cannot take the earned income credit.

Child Care Credit. In filling out the Form 2441, Child Care Credit, remember to include other types of excludable income in figuring the size of the Child Care Credit (e.g., military housing allowances). FEI is in this category according to the IRS. In a private letter ruling, the IRS said it was permissible for the taxpayer to exclude FEI via the Form 2555 and to include it for purposes of the Form 2441. While there are no guarantee the IRS will let you take the child care credit while excluding FEI, the logic of this ruling and a reading of the Form 2441 suggest you can probably take the Child Care Credit even though you are excluding FEI. You may, however, have to reduce the credit claimed. It may be necessary to figure the child care credit by treating the FEI as if it were taxable for purposes of calculating the child care credit. Compare the FEI to the total income and reduce the child care credit by that percentage. For example, if the spouse's FEI is 20% of the couple's total income, you reduce the child care credit by 20%.

State Income Taxes. If you exclude FEI for federal tax purposes, is the income also excluded for state income tax purposes? Not necessarily, since it depends on the state and its tax laws. Some states explicitly recognize a version of FEI, some implicitly recognize it (e.g., by exposing only your federal adjusted gross income to state taxation), and many do not recognize it at all. You would be wise to carefully examine your state tax returns to determine if you can exclude your income for state purposes as well.

FEI and Self-Employment Tax. Self-employment tax is a special tax which provides funds for social security benefits. It is paid by people who are "self-employed" (i.e., child care providers). Typically taxpayers who are "independent contractors" do not have FICA automatically taken from their income by their employers because they are by nature and definition self-employed. You fill out Schedule SE to pay the self-employment tax, but only if your self-employment income is \$400 or more.

What separates an employee from being considered self-employed or as an independent contractor? Generally, if an employer has the right to control or direct only the result of work and not the means and methods of accomplishing it, then you are self-employed. To put it another way, if the employer can tell you what to do, how to do it, and provides you with the tools to do the job, then you are probably an employee. If you are an employee, then you do not need to fill out the Schedule SE; and it is the employer's responsibility to pay the FICA by deducting it in part from your income and by contributing matching funds.

If you receive a Form 1099 MISC (Nonemployee Compensation Form) instead of a W-2 from the person you work for, you probably are self-employed; and your income is probably subject to self-employment tax. Even if you do not receive a Form 1099 MISC, you could still be subject to self-employment taxes.

A good example is someone who, while stationed overseas, offers child care services in his own home and determines the nature and manner of the services performed. If this person makes \$400 or more, then self-employment taxes must be paid. Usually, if the person provides child care in the child's home, then the IRS does not view the person as self-employed. Under either situation, of course, the child care provider probably could exclude the income as FEI. In the final analysis, whether you are an employee or are self-employed and whether you are subject to self-employment taxes or not, depend on all the facts and circumstances listed above.

If you are claiming the status of being self-employed/an independent contractor to take advantage of the FEI exclusion (e.g., because of the appearance that you are ostensibly working for the U.S. government overseas), you can't turn around and claim that you don't have to file a Schedule SE because it is the "employer's" responsibility.

If you determine you have self-employment income, remember to file a Schedule C and list the expenses you have incurred in pursuing your line of self-employment. Then reduce the amount of self-employment income you've received by your expenses, which will in turn reduce the amount of self-employment tax to which you'll be subject. Although the entire amount of "Foreign Earned Self-Employment Income" is excludable (up to a maximum of \$76,000), by adjusting downward this amount with your Schedule C listed expenses, you will reduce your self-employment tax.

In 1992, the IRS introduced Form 2555-EZ, Foreign Earned Income Exclusion, for taxpayers who had FEI of only wages and salaries of \$78,000 or less. Check with your unit tax advisor to see if you can use the Form 2555-EZ.

See IRS Publication 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad; IRS Publication 514, Foreign Tax Credit for Individuals; IRS Publication 516, Tax Information for U.S. Government Civilian Employees Stationed Abroad; and IRS Publication 593, Tax Highlights for U.S. Citizens and Residents Going Abroad; for more information.

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**TAX
INFORMATION
FOR FOREIGN
SPOUSES**

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TAX INFORMATION FOR FOREIGN SPOUSES

INTRODUCTION.

The tax rules that apply to a foreign national spouse of a military member stationed overseas are complicated, but could furnish certain federal income tax advantages. For instance, a member stationed in a foreign land and married to a foreign spouse who works on the local economy has the ability to file "married filing jointly," but exclude the spouse's "foreign earned income." Many, unaware of the applicable tax laws, have lost thousands of dollars in tax savings over the years. Review this guide for an overview of the tax rules and consult a tax advisor.

Under U.S. tax law, "resident" aliens are taxed on their income from all sources, both within and outside the U.S., in the same manner as U.S. citizens. This is so regardless of where they live (however, the foreign earned income exclusion rules would apply to their income earned while outside the U.S., from non-U.S. Government sources).

"Nonresident" aliens, regardless of where they live, are taxed only on their income from sources from "within the United States" (defined in detail later). Therefore, in contrast to resident aliens, if a nonresident alien earns income overseas from a U.S. Government source, he does not have to pay U.S. taxes. The rate at which the income of nonresidents from sources "within the United States" is taxed depends on the type of income earned. Income from investments is taxed at a flat rate unless the rate is reduced by treaty. Income from business activities, such as the performance

of personal services in the U.S., is taxed, after deductions, at graduated rates.

Taxable income, the rate of tax, rules for filing jointly and claiming your spouse as an exemption, and the forms required to be filed all depend on whether the foreign national is a "resident" alien (non-U.S. citizen who is a resident of the U.S.) or a "nonresident" alien (non-U.S. citizen who is not a resident of the U.S.). It is important to determine at the outset whether the foreign national spouse is a resident or a nonresident alien.

RESIDENT ALIENS. An alien is deemed a resident if he has been given the privilege of residing (permanently in the U.S. as an immigrant (the so-called "green card test" or "lawful permanent residence test") or meets the requirements of the "substantial presence test" which requires the person to have been present in the U.S. for at least 31 days during the calendar year; have been present in the U.S. within the last three years for 183 days using a special formula found in the Internal Revenue Code Sec. 7701(b); not have a tax home in a foreign country or a closer connection to a foreign country than to the U.S.; and have spent more than 182 days in the U.S. during the current calendar year.

The 1986 Tax Reform Act allows an alien to elect to be treated as a resident alien although he moved to the U.S. too late in the calendar year to satisfy, for that year, the substantial presence test. There is a series of requirements which must be met in order to obtain this election: you must not have qualified for resident status in the calendar year preceding the year of election; you

must meet the substantial presence test the year following the year of election; and you must be present in the U.S. for at least 31 consecutive days during the year you wish to elect to be treated as a resident and be present in the U.S. 75% of the time from the beginning of the 31-day period until the end of the election year.

CITIZENS OF U.S. POSSESSIONS AND TRUST TERRITORIES. A citizen of a U.S. possession or trust territory (i.e., American Samoa, Baker Island, Commonwealth of the Northern Mariana Islands (CNMI), Federated States of Micronesia, Howard Island, Marshall Islands, Midway Islands, Jarvis Island, Kwajalein Atoll, Palau, Johnston Island, Wake Island, but not Guam, Puerto Rico or the Virgin Islands), who is not naturalized, is a nonresident alien unless he qualifies to be a citizen under one of the rules above.

Citizens of Puerto Rico are considered resident aliens. Citizens of the Virgin Islands pay their taxes to the Treasury of the Virgin Islands, Bureau of Internal Revenue, Charlotte Amalie, St. Thomas, VI 09801. Self-employment taxes are paid to the U.S. Treasury on the Form 1040SE. Citizens of Guam do not file with the IRS, but must report all income, including income from U.S. sources, to the Commissioner of Revenue and Taxation, Government of Guam, Agana, Guam 96910. The 1986 Tax Reform Act, however, gives permission to American Samoa and Guam to develop their own local income tax systems. These systems will be coordinated with the U.S. tax system.

CHANGING STATUS. Once resident alien status is acquired, it is lost only by physical departure from the U.S., coupled with an intent to abandon residence in the U.S. (e.g., leaving the U.S. without notifying the Immigration and Naturalization Service or applying for a permit to reenter). On the other hand, a resident alien who leaves the U.S. pursuant to his spouse's military orders remains a resident alien as long as the spouse serves outside the U.S. because of military orders.

FILING. Foreign nationals who are resident aliens for the entire year are treated like U.S. citizens for tax purposes. Resident aliens are taxed on world-wide income, may file joint or separate, may use a 1040 or 1040A, and may claim citizen children as exemptions.

NONRESIDENT ALIENS (NRAs). Foreign nationals, admitted to the U.S. on a limited visa for a definite period whose purpose for the visit does not require an extended stay, are considered to have nonresident alien status. Temporary residents and travelers are nonresident aliens. Questions concerning status should be directed to the Director of International Operations, Internal Revenue Service, Washington, D.C. 20225. Basically, if you do not meet the tests of residency (i.e., the green card/lawful permanent residence test or the substantial presence test), you are a nonresident alien.

FILING. Nonresident aliens are taxed only on income earned from sources "within the United States," unless they elect to file jointly with a citizen or a resident alien. If there is no election, the nonresident alien is required to file Form 1040NR, but only if there is U.S.-source income.

SOURCES WITHIN THE U.S. These include dividends received from domestic corporations, wages from personal services rendered in the U.S., rents and royalties from property in the U.S., or profits on gains from the sale of real or personal property in the U.S. Interest from most overseas U.S. banking facilities is not considered income from within the U.S. Employment of a nonresident alien by the U.S. Government overseas is not considered income from within the U.S.

FILING A SEPARATE RETURN. A citizen or resident alien spouse, not making the election to file jointly, must file the Form 1040 or 1040A in the "Married Filing Separate" status, unless qualified for "Head of Household" status (where the taxes are at a more favorable rate than married filing separately).

Exemptions. When filing separately, the taxpayer may claim an exemption for the NRA spouse if the NRA spouse has no income from within the U.S. and is not a dependent of another taxpayer.

Head of Household. A taxpayer may file as Head of Household even though his spouse was an NRA at any time during the year. This can be done as long as the taxpayer pays more than half the cost of maintaining a home that is the main home for the entire year for the taxpayer's child, stepchild, foster child, or adopted child who lives with the taxpayer; or the taxpayer's parent or other relative (except the NRA spouse) not living with the taxpayer, but which the taxpayer can legally claim as a dependent.

Married Filing Jointly. The filing status of "married filing jointly" offers a taxpayer the most favorable tax rates. The tax law allows

a taxpayer, married to an NRA, to file jointly if an election is made. This election treats both spouses as U.S. residents for all income tax purposes, including subjecting the NRA spouse's world-wide income to U.S. income tax. If your spouse is working overseas for a non-U.S. Government source, he will be entitled to exclude this income using the Foreign Earned Income exclusion. In such a case, filing a joint return can offer significant tax savings. You can take advantage of more favorable tax rates, the personal exemption, and the special standard deductions if your spouse is blind or over 65.

To elect to file jointly, you need to attach a statement to your tax return (i.e., using either the Form 1040 or 1040A--the 1040NR is not required). This election may be terminated in one of four ways: (1) the death of either spouse; (2) legal separation; (3) inadequate records in the eyes of the IRS; or (4) explicit revocation. If you decide to revoke (method #4), you may do so by attaching a statement to your tax return. Be aware, however, that once you revoke, you can never reelect again. Only by your spouse becoming a resident alien or a citizen could you file jointly again.

Dual Status. An NRA has dual status for tax purposes in a year in which he has been both a resident and a nonresident alien. A dual status alien, unless electing to file a joint return, is taxed on income from all sources for the portion of the year he is a resident alien, and is only taxed on income from within the U.S. for the portion of the year he is a nonresident alien.

FILING REQUIREMENTS. If you are filing separate returns and the spouse is a resident alien on the last day of the year, use the

Form 1040 or 1040A for the period of the year the spouse was a resident, and write across the top of this return: "Dual Status Return." In addition, the NRA spouse should file a 1040NR for that portion of the year he was a nonresident and write the word "Statement" across the top.

If you are filing separate returns and the spouse is a nonresident alien the last day of the year, file a Form 1040NR for the period of the year the spouse was a nonresident, and write the words "Dual Status Return" across the top. Also file a Form 1040 or 1040A to reflect the income earned while a resident during the year, with the word "Statement" written across the top of the form.

If you are filing jointly, as indicated above, you need to file an election statement along with your Form 1040 or 1040A and include all of your spouse's income--income earned as a resident and income earned as a nonresident, regardless of the spouse's status on the last day of the year.

SPECIAL RESTRICTIONS ON DUAL STATUS RETURNS. The tax tables may not be used and the NRA cannot take advantage of the standard deduction. A dual status taxpayer may not file as head of household and must use the tax rate schedule for married filing separately, unless there is an election to file a joint return. A dual status taxpayer is entitled to a personal exemption and exemptions for the spouse and qualified dependents. The amount claimed is limited to the taxable income for the part of the year the taxpayer was a resident. Finally, all income for the period of residence, after allowable deductions, is totaled and subject to a graduated tax; all income for the period of nonresidence is subject to a flat tax rate.

Consult IRS Publication 519 when computing this tax.

NONRESIDENT ALIENS OF COMMUNITY PROPERTY STATES.

Before 1977, a taxpayer married to an NRA, who was a resident of a community property state, had a tax windfall. Community property state laws provided that one-half of the military member's income was the spouse's. A couple stationed overseas, not electing to file a joint return, could be taxed on only half of the earned income. The military member filed a 1040, reporting only his share. The NRA spouse, however, would not have to file or pay tax on his share because it was considered non-U.S. source income. The law now requires that the income must be reported on the return of the one who actually earned or produced it. Keep in mind, however, that some community property states, for state tax purposes, may still allow this split.

**2001
TAX
INFORMATION
SERIES**

**MOVING EXPENSE
ADJUSTMENT**

This pamphlet provides information concerning your federal income taxes. If you have legal questions concerning your taxes, and your unit tax advisor is unable to answer them, call the number below for an appointment to see a lawyer.

**LEGAL ASSISTANCE TELEPHONE
NUMBER**

OFFICE OF THE STAFF JUDGE ADVOCATE

MOVING EXPENSE ADJUSTMENT

Moving expenses are an adjustment to gross income and may be claimed only on Form 1040. Service members don't need to satisfy the time and distance tests for moving expense adjustments (explained in IRS Publication 521) to qualify for the moving expense adjustment, they need only move pursuant to PCS orders. As explained below, however, few service members will be able to deduct any moving expenses.

The tax law changed in 1994. **Since 1994**, taxpayers **may deduct only unreimbursed expenses incurred for**:

- (1) Moving their household goods and personal effects (including in-transit or foreign move storage expenses) **AND**
- (2) Traveling (including lodging, but not meals) to their new home.

Before 1994, the following items were deductible as moving expense:

- (1) Meals while moving from the old residence to the new residence;
- (2) Travel expenses, meals, and lodging for pre-move househunting trips;
- (3) Meals and lodging while occupying temporary quarters at the new job location;
- (4) Expenses connected with buying or selling a home; and
- (5) Expenses connected with getting or breaking a lease;

Because the government did not usually reimburse service members for these five (frequently incurred expenses), service members were usually able to take a deduction for moving expenses on their income tax return. However, since 1994, the five items listed above are **no longer deductible** as moving expenses.

Because the Government pays the cost of shipping the household goods of military members and pays the transportation costs of military members and their family members when they PCS, and because these are now the only two categories of deductible moving expenses, most service members will have no unreimbursed moving expenses and will not be able to take a deduction for moving expenses.

Additionally, even if the military member has some unreimbursed expenses for (1) moving their household goods and personal effects (for example shipping a second car to or from Europe) or (2) traveling to their new home, they may only deduct these expenses to the extent the expenses exceed the amount they receive as a dislocation allowance. This change reflects an agreement with the Internal Revenue Service that they would not tax the dislocation allowance paid to service members; in exchange for this tax free treatment, service members could only deduct moving expenses to the extent they exceeded their tax free dislocation allowance.

For more information, see IRS Publication 521, [Moving Expenses](#) or contact your local legal assistance attorney or unit tax officer.

MOVING EXPENSE CHECKLIST

(USE WITH IRS FORM 3903 OR 3903F)

The next four pages contain a moving expense checklist for use in recording your PCS moving expenses. Use of this form while moving will reduce the time required to "reconstruct" records at tax time.

You may only deduct moving expenses that are neither paid for nor reimbursed by the government. Additionally, even if you have unreimbursed moving expenses, you may only deduct them to the extent they exceed the amount you received as a dislocation allowance.

PERSONAL DATA:

1. Name, Rank, Branch of Service: _____
2. Date of Reassignment: _____
3. Old Duty Station: _____
4. Date of Departure This Station: _____
5. New Duty Station: _____
6. Date of Arrival This Station: _____

EXPENSES INCURRED:

1. Expenses of Moving Household Goods and Personal Effects:
 - a. Amount paid to household goods mover or transporter of mobile home: _____
 - b. Amount paid to pack and crate household goods if a separate payment was made for this purpose: _____
 - c. Amount paid to ship or mail essential items needed immediately upon arrival: _____
 - d. Cost of insurance on property in transit: _____

(You may not deduct the annual premiums of your household goods policy. However, if you buy a special policy to cover either all of your household goods or only the high-value items and

the policy's coverage is limited to the period your property is in transit or is in storage during transportation, you may deduct the premium paid to secure the policy.)

e. Cost of shipping a household pet: _____

f. Cost of shipping an automobile: _____

(1) Expense of driving car to shipping agent or port (actual expenses or ten cents per mile): _____

(2) Cost of lodging while driving car to agent or port and returning to base: _____

(3) Premium for special insurance to cover damage to car during shipment: _____

(4) Shipping agent's fee: _____

(5) Charge for shipping car: _____

(6) Cost of agent to receive car at port and drive it to port of entry or place of your duty assignment: _____

(7) Wharfage fees at port: _____

(8) Cost of transportation to pick up car at port (include taxi fare, train fare, car rental costs, cost of operating a private vehicle -- actual expenses or \$0.12 per mile): _____

(9) Cost of lodging while traveling to pick up your car: _____

TOTAL OF SECTION 1: _____

2. Expenses of Personal and Family Travel and Lodging:

a. Cost of lodging for you and your family from the time of departure from old base until time of arrival at new base: _____

b. Cost of transportation for you and your family:

(1) Cost of driving an automobile: _____

(You may deduct only expenses of transportation by the most direct route. If you take leave en route or visited friends, use only the costs you would have paid on a direct point-to-point trip.)

(a) Tolls: _____

(b) Either: _____

\$0.12 per mile x _____ miles
(Use if you did not keep records) _____

OR

Actual Expenses (use if you kept records)

Gas: _____

Oil: _____

Repairs: _____

Total actual expenses: _____

TOTAL COST OF DRIVING: _____

(2) Cost of commercial transportation: _____

(You may deduct only expenses of transportation by the most direct route. If you take leave en route or visited friends, use only the costs you would have paid on a direct point-to-point trip.)

(a) Limousine or taxi to depot or airport: _____

(b) Bus, train or air fare: _____

(c) Other: _____

TOTAL COST COMM. TRANSPORTATION: _____

(Members who have traveled to, or returned from an overseas tour of duty should have included in the section 2 expenses listed above the following items if they were incurred.)

- (1) Cost of lodging for you and your family from the time you departed your old base until the time you boarded the flight.
- (2) Cost of transportation from old base to point of debarkation.
- (3) Cost of lodging during travel from point of debarkation to arrival at new duty

station. (DO NOT INCLUDE EXPENSES INCURRED WHILE ON
LEAVE.)

- (4) Cost of air fare from point of debarkation to point of entry.
- (5) Cost of transportation from point of entry to new duty station.

SUMMARY

TOTAL UNREIMBURSED MOVING EXPENSES

(MINUS)

AMOUNT RECEIVED AS A DISLOCATION ALLOWANCE

(EQUALS)

DEDUCTIBLE MOVING EXPENSES

***FOR MORE INFORMATION, SEE IRS PUBLICATION 521, MOVING EXPENSES OR
CONTACT YOUR LOCAL LEGAL ASSISTANCE ATTORNEY OR UNIT TAX OFFICER.***

**2001
TAX
INFORMATION
SERIES**

**U.S. SERIES EE & I
SAVINGS BONDS**

This pamphlet provides information concerning your federal income taxes. If you have legal questions concerning your taxes, and your unit tax advisor is unable to answer them, call the number below for an appointment to see a lawyer.

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OFFICE OF THE STAFF JUDGE ADVOCATE

U.S. SERIES EE SAVINGS BONDS

More and more taxpayers are investing in U.S. Savings Bonds. The popularity of Savings Bonds is due in large part to their safety, relatively low cost, and tax deferral advantages. Since 1990, the Bonds have had an added feature that will allow owners to entirely exclude interest accrued on the Bonds if used to pay for qualified educational expenses.

Series EE Savings Bonds are sold for half of their face value. When held for five years or more, the interest on EE Bonds becomes market based, retroactive to the first day of purchase. The bonds currently receive interest at either 85% of the average return during that time on marketable Treasury securities with five years remaining to their maturity or a guaranteed minimum of four percent.

Some investors purchase Series EE Savings Bonds for their favored tax treatment under the code which gives owners a choice in reporting interest. Taxpayers may pay tax on interest as it accrues or defer paying tax on the interest until the bond is redeemed. Interest on Series EE Bonds escapes state and local income tax altogether.

The tax treatment of Series EE Bonds makes them an attractive investment for saving for college education for children. If the Bonds are purchased in the child's name, the accrued interest is taxable to the child when the Bonds are redeemed, usually at a time when the child will probably be in a lower tax bracket than his parents. Alternatively, children owners may elect to report the interest as it accrues and use their annual standard deduction to reduce or

eliminate tax altogether. Children who elect this method of reporting interest should file a 1040EZ tax return for the first year in which Bonds are owned even if no tax is due.

The election to use one method of reporting is not irrevocable; the IRS will allow Bond owners to switch the method of reporting interest. Thus, Bond owners have the flexibility of reporting Bond interest as current income for a few years, then switching over to postpone the interest, and then changing back to the accrual method. Taxpayers can make the switch only once every five years and, when a switch is made, it applies to all Bonds owned by the taxpayer. To change methods of reporting, taxpayers must complete IRS Form 3115 and attach it to the federal income tax return for the year concerned.

Starting in 1990, there has been an alternative method for using Series EE Bonds for college savings plans. The interest on qualified U.S. Savings Bonds issued after 1989 is entirely free from federal tax if used to pay for higher education costs.

There are four basic restrictions to the qualified Savings Bond exclusion program. First, the exclusion is available only for Bonds purchased on or after January 1, 1990. Bonds purchased before this date will not qualify. Secondly, the Bond must be issued to an individual who is at least 24 years old. Thus, a parent or grandparent must own the Bond and, if it later turns out that the Bonds will not be used for college expenses, the accrued interest will be taxed to that individual.

Third, the exclusion is phased out as the adjusted gross income of the taxpayer exceeds certain levels depending on the owner's filing status. For married taxpayers filing jointly and surviving spouses, the exclusion of the interest begins phasing out at \$81,100 and is completely phased out at \$111,100 for 2000. For all other taxpayers, the exclusion of the interest begins phasing out at \$54,100 and is completely phased out at \$69,100 for 2000. The final requirement is that the amount of the interest on the redeemed Bonds must be lower than qualified higher educational expenses of the child, the taxpayer, or a spouse. Educational costs are broadly defined as including tuition and fees (not room and board or expenses for courses involving sports, games, or hobbies that are not part of a degree program). Thus, it is possible that the exclusion will not be available if the child receives a scholarship or attends a military service academy.

Taxpayers must distinguish the tax reporting rules for Series EE Savings Bonds from those that apply to HH Bonds. Series HH Bonds are current income securities that are available only in exchange for eligible Series EE or E Savings Bonds with total redemption values of \$500 or more. Interest on Series HH Bonds is paid semiannually and must be reported for the year in which it is paid. The interest is not subject to state or local income tax.

FEATURES OF I BONDS

I Bonds are a new type of bond designed for investors seeking to protect the purchasing power of their investment and earn a guaranteed real rate of return. I Bonds are an accrual-type security--meaning interest is added to the bond monthly and

paid when the bond is cashed. I Bonds are sold at face value--you pay \$50 for a \$50 bond--and they grow in value with inflation-indexed earnings for up to 30 years.

The Treasury is offering the I Bond to encourage more Americans to save for the future. We are offering investors a bond with a fixed rate combined with semiannual inflation adjustments that will help protect purchasing power. The I Bond will not replace Series EE bonds; both will be on sale to give investors a choice.

The earnings rate of an I Bond is a combination of two separate rates: a *fixed rate of return* and a variable *semiannual inflation rate*. The fixed rate remains the same throughout the life of the I Bond, while the semiannual inflation rate can vary every six months. The *fixed rate of return* is announced by the Treasury Department each May and November. The fixed rate of return announced in May of a given year is the same over the entire life of the I Bonds you purchase between May 1 and October 31 of that year. Likewise, the fixed rate of return announced in November of a given year applies to the entire life of I Bonds you purchase between November 1 and April 30 of the following year. The *semiannual inflation rate* is also announced each May and November by the Treasury Department. The semiannual inflation rate is based on changes in the Consumer Price Index for all Urban consumers (CPI-U), which is reported by the Bureau of Labor Statistics. The semiannual inflation rate announced in May is a measure of inflation over the preceding October through March; the inflation rate announced in November is a measure of inflation over the preceding April through September. The semiannual inflation rate is combined

with the fixed rate of an I Bond to determine the I Bond's earnings rate for the next six months.

I Bonds increase in value each month, and interest is compounded semiannually. I Bonds increase in value on the first day of the month. An I Bond's issue date is the month and year when the full issue price is received by an I Bond issuing agent.

I Bonds are U.S. Treasury securities backed by the U.S. Government. I Bonds even protect you from the effects of deflation. In the rare event that the CPI-U is negative during a period of deflation and the decline in the CPI-U is greater than the fixed rate, the redemption value of your I Bonds will remain the same until the earnings rate becomes greater than zero. I Bonds earn interest for up to 30 years.

Earnings are exempt from state and local income taxes. Federal income taxes can be deferred for up to thirty years, or until redemption or other taxable disposition, whichever comes first.

If you qualify, you can exclude all or part of the interest on I Bonds (and on eligible EE bonds) from income as long as the proceeds are used to pay for tuition and fees at eligible post-secondary educational institutions

INVESTING IN AND REDEEMING I BONDS

On September 1, 1998, six denominations (\$50, \$75, \$100, \$500, \$1,000, and \$5,000) were made available for purchase through financial institutions across the country. Two additional

denominations (\$200 and \$10,000) were added in May 1999.

I Bonds fit all budgets. They are sold at face value in denominations of \$50, \$75, \$100, \$200, \$500, \$1,000, \$5,000, and \$10,000. This makes it easy to keep track of the growth of your bond's value.

You can only buy up to **\$30,000** worth of I Bonds each calendar year. The purchase limitation for Series I Bonds isn't affected by purchases of Series EE Bonds.

You can order I Bonds at most local financial institutions. You just fill out a simple purchase order, pay for the bond, and your I Bond will be mailed to you within three weeks. I Bonds are also available through employer-sponsored payroll savings plans. Check with your employer to see if I Bonds are available where you work. If not, let them know you're interested!

I Bonds are great gifts for all occasions. An I Bond can be sent to you so you can present it personally or it can be sent directly to the person receiving the gift. When you buy the I Bond, ask for a free gift certificate. The word "gift" won't appear on the I Bond.

U.S. citizens, residents, and workers of any age with a valid U.S. social security number can own I Bonds.

There are three primary ways to register I Bonds:

- Single ownership: Only the registered owner can cash the I Bond.
- Co-ownership: Two individuals' names appear on the I Bond; either person may cash the I Bond without

the knowledge or approval of the other. Upon the death of one co-owner, the other becomes the sole owner of the I Bond.

- Beneficiary: Only the owner may cash the I Bond during his or her lifetime. The beneficiary automatically becomes the sole owner of the I Bond when the original owner dies. The registration on an I Bond can be changed, but there are some restrictions.

records of your I Bond serial numbers, issue dates, and the social security or taxpayer identification numbers in a safe place. This information will help speed up the replacement process.

Most financial institutions serve as paying agents for I Bonds and Series EE Bonds. If they redeem Series EE Bonds, they also redeem I Bonds.

You can cash an I Bond anytime six months after the issue date to get the original investment plus the earnings. However, I Bonds are meant to be longer-term investments. So, if you redeem an I Bond within the first five years, there is a 3-month earnings penalty. For example, if you redeem an I Bond after 18-months, you'll get 15 months of earnings.

Series EE Bonds can't be exchanged for I Bonds. You can cash the EE Bonds and use the proceeds to buy I Bonds; however, the interest earned on the EE Bonds must be reported on your Federal income tax return for the year in which they were cashed. I Bonds can't be exchanged for Series HH Bonds.

The Bureau of the Public Debt is authorized to replace lost, stolen, or destroyed I Bonds. You can file a claim by writing to: Bureau of the Public Debt, Parkersburg, West Virginia 26106-1328. You'll need to complete Form 1048. Keep

**2001
TAX
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**CHILD &
DEPENDENT CARE
CREDIT**

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CHILD & DEPENDENT CARE CREDIT

A. Generally, a taxpayer who maintains a household that included one or more qualifying individuals (dependents under age 13 or dependents mentally or physically incapable of self-support) can take a credit for up to 20% to 30% of the work-related expenses the taxpayer paid for the care of the qualifying individuals. The expenses are subject to earned income and dollar limitations.

B. The credit is available to an individual who incurred employment-related expenses that enable gainful employment or search for employment. Qualifying individuals are:

1. Dependents of the taxpayer who are under 13 when the care was provided and for whom the taxpayer is entitled to a dependency exemption under IRC Section 151(c).

2. Dependents of the taxpayer who are physically or mentally incapable of caring for themselves regardless of age, even if they have gross income in excess of the exemption amount. The person can be a spouse or any other dependent. The disability is determined on a daily basis; so if the disability is removed during the year, the taxpayer may still claim the credit for that part of the year the dependent is disabled. Treas. Reg. Section 1.44A-1(b)(3). The person must be incapable of caring for hygienic or nutritional needs or require full time attention of another for safety. Treas. Reg. Section 1.44A-1(b)(3).

C. There is a dollar limit on the amount of your work-related expenses that you can

use to figure the credit. This limit is \$2,400 for one qualifying person, or \$4,800 for two or more qualifying person.

D. The credit is the applicable percentage times the expenses paid. The percentage is 30% reduced, but not below 20%, by one percentage point for each \$2,000 (or fraction of \$2,000) by which the taxpayer's adjusted gross income (AGI) exceeds \$10,000. Thus, if the AGI is \$10,000 or less, the taxpayer gets the maximum of 30%; but if the AGI exceeds \$28,000, the taxpayer gets the minimum of 20%. Regardless of the actual expenses, the maximum dollar amount to be applied to the percentages is \$2,400 for one qualifying individual and \$4,800 for two or more qualifying individuals.

Example: If the taxpayer has AGI of \$35,000, the 20% limit would apply. If this taxpayer had one qualifying dependent, the maximum credit would be \$480 ($20\% \times \$2,400 = \480).

E. The dollar limitation is reduced by the aggregate amount excluded from gross income under IRC Section 129 for dependent care assistance. The dollar limitation also is limited to earned income of the taxpayer or spouse (if spouse's earned income is less) if the earned income is less than the \$2,400 or \$4,800. If a spouse is a full-time student, that spouse is treated as employed with income of not less than \$200 per month for one qualifying individual and \$400 per month for more than one qualifying individual.

F. Earned income includes wages, salaries, tips, other employee compensation, and self-employment income. It also includes disability pensions. Treas. Reg. 1.44A-2(b)(2). Earned income is determined without regard to community property laws. It does not include unemployment compensation, social security payments, or worker's compensation. Treas. Reg. 1.44A-2(b)(2).

G. If the parents of a qualifying child are divorced, the noncustodial parent cannot get the credit even if the noncustodial parent claims the child as a dependent for exemption purposes due to the custodial parent's release or a qualified pre-1985 instrument giving the exemption to the noncustodial parent.

H. A taxpayer maintains a household for any period if he furnished over half the cost of maintaining the household for the year. Costs include rent, mortgage interest, taxes, utility charges, repairs, insurance, and food. They do not include clothing, education, medical treatment, vacations, life insurance, transportation, or mortgage principal. Treas. Reg. 1.44A-1(d)(1) and (3).

I. Expenses are employment-related if they are paid for household services or for the care of a qualifying individual and they enable the taxpayer to be gainfully employed. The expenses must be somehow related to the care of the qualifying individual. Educational expenses for the qualifying individual are not credible expenses unless the costs are inseparably a part of the care (like nursery school). Treas. Reg. Section 1.44A-1(c)(3)(i). Expenses incurred for the transportation of a qualifying individual between the home and

the place where care is provided are not creditable. Treas. Reg. Section 1.44A-1(c)(3)(i). Costs paid to a dependent care center outside the taxpayer's home are creditable if the center complies with all applicable laws and regulations of a state or local government.

J. Expenses must be incurred while the taxpayer is either gainfully employed or searching for employment.

K. No credit is allowed if the payment is to a dependent of the taxpayer or a child of the taxpayer under 19 at the close of the year.

L. No credit will be allowed unless the name, address, and ID number of the care provider is included in the taxpayer's return. This information is provided on Schedule 2 of Form 1040A, Form 2441, or Form W-10. IRC Section 21(e)(9). If the information is not provided, the credit will not be allowed unless it is shown that the taxpayer exercised due diligence in attempting to provide the information. IRC Section 21(e)(9)(B). Where the child care provider does not have a social security number because he is a foreign national, the taxpayer should indicate that the provider does not have a social security number.

See IRS Publication 503, Child and Dependent Care Expenses, for more information.

**2001
TAX
INFORMATION
SERIES**

**EARNED INCOME
CREDIT**

This pamphlet provides information concerning your federal income taxes. If you have legal questions concerning your taxes, and your unit tax advisor is unable to answer them, call the number below for an appointment to see a lawyer.

**LEGAL ASSISTANCE TELEPHONE
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OFFICE OF THE STAFF JUDGE ADVOCATE

EARNED INCOME CREDIT

Earned Income Credit (EIC) is a refundable credit that is treated like a payment, such as withheld income tax. You may receive a refund even though you never paid any tax or had any tax withheld. EIC provides tax relief to low-income workers, including certain workers with no children. The EIC is available to members of the armed forces stationed overseas.

Claiming EIC. Eligible taxpayers are:

Married taxpayers who are entitled to a dependency exemption for their child, grandchild, eligible foster child, or stepchild.

Married taxpayers generally must file married filing jointly.

Certain married taxpayers who live apart from a spouse need not file a joint return to claim the credit.

A custodial parent, even if that parent agrees to allow the noncustodial parent to claim the child as a dependency exemption.

Surviving spouses.

Heads of households who maintain a home for a child, adopted child, stepchild, eligible foster child, or descendant of a child. (A married child must qualify as a "dependent" for whom the taxpayer is entitled to a dependency exemption.)

Those who seek to include eligible foster children in their households for purposes of the EIC face additional requirements. Previously, a child was an eligible foster child for the EIC if the taxpayer cared for the child as they would their own child and the child lived with the taxpayer for the whole year (except for temporary absences). Beginning in 2000, in addition to the prior rules mentioned, the child must be a brother, sister, stepbrother, or stepsister (or a descendant of your brother, sister, stepbrother, or stepsister) or have been placed with the taxpayer by an authorized placement agency.

Workers without qualifying children with earned income (or adjusted gross income) of less than \$10,710.

The taxpayer's principal place of abode for more than half of the tax year must be in the "United States" or the taxpayer must be a member of the armed forces stationed overseas.

The taxpayer (or the taxpayer's spouse) must be 25 years of age or older (but not 65 years of age or older) before the end of the tax year.

The taxpayer (or the taxpayer's spouse) must not qualify as a dependent on another taxpayer's income tax return.

NOTE: Taxpayers who take advantage of the foreign earned income exclusion are **not** entitled to EIC for that tax year.

QUALIFYING TESTS.

Taxpayer with qualifying child(ren) must:

Have earned income of under \$28,281 if one qualifying child (\$32,121 if two or more qualifying children);

Have a qualifying child who lived with the taxpayer in the taxpayer's main home for more than 6 months of the tax year;

File a joint return if married; and

Complete and attach Schedule EIC to the tax return.

Taxpayer without qualifying child(ren) must:

Have earned income and AGI under \$10,710;

Have main home in U.S. for more than 6 months of the tax year (or overseas if a member of the armed forces stationed overseas);

Be at least 25, but under 65 (if filing jointly, either spouse may satisfy age component of test);

File a joint return if married; and

Not be a dependent or qualifying child of another taxpayer.

DEFINITIONS.

Earned Income. Includes both taxable and nontaxable earned income.

Wages, salaries, tips, and other employee compensation.

Military taxpayers must include BAQ (minimum BAH) and BAS in "earned income." EIC Worksheet, line 4, includes BAQ, BAS, and combat pay, but not VHA or COLA. This amount will appear on the military taxpayer's W-2 Form in Block 12 as amount next to "Q."

Qualifying child. Taxpayer's son, daughter, adopted child, grandchild, stepchild, or foster child who at the end of the tax year was under 19 (or under 24 and a full-time student), or any age if permanently and totally disabled.

Household requirement. The qualifying child must have lived in the taxpayer's main home for more than 6 months of the tax year. (Foster child must have lived there for all of the tax year.)

Qualifying child must have lived with taxpayer in same main home for more than one-half of the year.

Taxpayer may still satisfy this requirement if away from home on a temporary absence due to special circumstance. Temporary absence examples: illness, attending school, business, military service.

Example: Military taxpayer may be eligible for EIC if absent temporarily only because of military service. PFC Jones is stationed in Germany. After his tour, he intends to return to the U.S. where his wife and 6-month-old son (qualifying child) reside. Assuming the Jones's will file a joint return and have an adjusted gross income below \$28,281, they may claim the EIC.

If a taxpayer is receiving EIC because of a qualifying child, the child must reside in the same principal place of abode as the taxpayer for more than one-half of the taxable year. The principal place of abode must be located in the United States. For purposes of determining whether a qualifying child meets the residence test, the principal place of abode shall be treated as in the United

States for any period during which a member of the Armed Forces is stationed outside the United States while serving on active duty.

EXCESS DISQUALIFIED INCOME.

No credit is allowed if the taxpayer has excess disqualified income over \$2,400 for the tax year. Disqualified income means:

- Interest or dividends to the extent includable in gross income;

- Tax exempt interest;

- The excess of gross income from nonbusiness rents or royalties over the sum of the noninterest deductions that are clearly and directly allocable to that gross income and the interest deductions properly allocable to the gross income;

- The taxpayer's capital gain net income for the year;

- The excess of the aggregate income from all passive activities for the year over the aggregate losses from all passive activities for the tax year.

DISALLOWANCE OF EIC DUE TO FRAUD OR ERROR.

No credit is allowed for 10 years after a year in which the EIC was claimed fraudulently (two years for erroneously claimed credit due to reckless or intentional disregard of the rules). If the EIC is denied under deficiency procedures, no credit is allowed for any later tax year unless the taxpayer provides information the IRS requires demonstrating eligibility.

ADVANCE EARNED INCOME CREDIT PAYMENT.

If you expect to be able to claim the EIC in 2001 and a child lives with you, you may be able to get part of the credit in each paycheck instead of waiting until you file your 2001 federal income tax return. To do so, you notify your employer with Form W-5. Your employer will make advance payments of the EIC during the tax year to you and report these payments on your Form W-2.

SEE PUBLICATION 596, EARNED INCOME CREDIT, FOR MORE DETAILS.

**2001
TAX
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**COMBAT ZONE TAX
INFORMATION**

This pamphlet provides information concerning your federal income taxes. If you have legal questions concerning your taxes, and your unit tax advisor is unable to answer them, call the number below for an appointment to see a lawyer.

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OFFICE OF THE STAFF JUDGE ADVOCATE

COMBAT ZONE TAX INFORMATION

EXTENSION OF DEADLINE. Armed forces members who served in a combat zone **or a qualified hazardous duty area** are allowed additional time to take care of tax matters (called a "deadline extension" in this handout). The deadline for taking actions with the IRS is extended for at least 180 days after the later of:

1. The last day the taxpayer is in a combat zone (or the last day the area qualifies as a combat zone), or
2. The last day of any continuous qualified hospitalization for injury from service in the combat zone. (Qualified hospitalization is hospitalization which resulted from an injury received while serving in the combat zone.)

Beyond the 180 days, the deadline is also extended by the number of days that were left for the member to take action with the IRS when he entered the combat zone. If the member entered the combat zone before the time to take the action began, the deadline is extended by the entire time he has to take the action.

ACTIONS EXTENDED. The deadline extension provision applies to these actions:

1. Filing any return of income, estate, or gift tax (except employment and withholding taxes).
2. Paying any income, estate, or gift tax (except employment and withholding taxes).
3. Filing a petition with the Tax Court for redetermination of a deficiency or for review of a Tax Court decision.
4. Filing a claim for credit or refund of any tax.
5. Bringing a suit for any claim for credit or refund.
6. Purchasing a replacement residence to postpone paying tax on the gain on the sale of the old residence.
7. Making a qualified IRA contribution.
8. Allowing a credit or refund of any tax by IRS.
9. Assessment of any tax by the IRS.
10. Giving or making any notice or demand by the IRS for the payment of any tax or for any liability for any tax.
11. Collection by the IRS of any tax due.
12. Bringing suit by the United States for any tax due.

Note: If the IRS takes any actions listed on the previous page or sends a notice of examination before learning that the taxpayer qualifies for a deadline extension, the taxpayer should return the notice with "COMBAT ZONE EXTENSION" written across the top. No penalties or interest will be imposed for failure to file a return or pay taxes during the extension period. The IRS, however, will pay interest on a refund from the due date of the return if the return is timely filed after applying the deadline extension.

SPOUSES. Spouses of individuals who served in a combat zone are entitled to the same deadline extension with two exceptions:

1. The extension does not apply to a spouse for any tax year beginning more than two years after the date that combat activities end.
2. The extension does not apply to a spouse for any period the qualifying individual is hospitalized in the United States for injuries incurred in a combat zone.

COMBAT ZONE EXCLUSION. Armed forces members who serve in a combat zone **or a qualified hazardous area** (or in direct support thereof) may exclude certain pay from their income. They do not have to receive the pay while in a combat zone, but it must be paid for service there or for a period during which they were hospitalized as a result of their service there. The following military pay can be excluded from income:

1. Active duty pay earned in any month they served in a combat zone. Military members (enlisted or commissioned warrant officers), who serve in a combat zone during any part of a month, can exclude all of their basic pay for that month from income. For 2000, commissioned officers may exclude up to \$4,869 of their pay each month during any part of which they served in a combat zone.
2. A dislocation allowance if the move begins or ends in a month they served in a combat zone.
3. A reenlistment bonus if the voluntary extension or reenlistment occurs in a month they served in a combat zone.
4. Pay for accrued leave earned in any month they served in a combat zone.
5. Pay received for duties as a member of the armed forces in clubs, messes, post and station theaters, and other nonappropriated fund activities. The pay must be earned in a month the member served in a combat zone.
6. Awards for suggestions, inventions, or scientific achievements members are entitled to because of a submission they made in a month they served in a combat zone.

TAXPAYERS WHO SERVE IN A COMBAT ZONE SHOULD WRITE "COMBAT ZONE" ON THEIR TAX RETURN.

COMBAT ZONE. Presently there are three combat zones.

Desert Storm: The President, by Executive Order 12744, designated the following locations (including airspace) as a combat zone beginning 17 January 1991:

- * The Persian Gulf,
- * The Red Sea,
- * The Gulf of Oman,
- * The part of the Arabian Sea that is north of 10 degrees north latitude and west of 68 degrees east longitude,
- * The Gulf of Aden, and
- * The total land areas of Iraq, Kuwait, Saudi Arabia, Oman, Bahrain, Qatar, and the United Arab Emirates.

Allied Force: The President, by Executive Order 13119, designated the following locations (including airspace) as a combat zone beginning 24 March 1999:

- * The Federal Republic of Yugoslavia (Serbia/Montenegro);
- * Albania;
- * the Adriatic Sea;
- * the Ionian Sea north of the 39th parallel.

Afghanistan: The President, by Executive Order 13239, designated Afghanistan, including the airspace above, as a combat zone beginning 19 September 2001.

Qualified Hazardous Area: Service in Bosnia and Herzegovina, Croatia, and Macedonia after 21 November 1995. Also, the area designated as Operation Allied Force after 24 March 1999.

NOTE: As of 30 June 1997, Vietnam is no longer designated as a combat zone.

Qualifying service outside combat zone. Military service outside of a combat zone is considered performed in a combat zone if:

1. The service is in direct support of military operations in the combat zone, **and**
2. The service qualifies the member for special military pay for duty subject to hostile fire or imminent danger.

Military pay for this service will qualify for the combat zone exclusion if the other requirements are met.

Nonqualifying service in a combat zone. The following military service does not qualify as service in a combat zone:

1. Presence in a combat zone while on leave from a duty station located outside the combat zone.
2. Passage over or through a combat zone during a trip between two points that are outside of a combat zone.
3. Presence in a combat zone solely for a member's personal convenience.

Consult IRS Publication 945, Tax Information for Those Affected by Operation Desert Storm, for more information.

FORM W-2. The wages shown on the 2001 Form W-2 should not include military pay excluded from an individual's income under the combat zone exclusion provisions. Contact your local finance office if you have questions about the exclusion.

CIVILIANS: The deadline extension provisions also apply to certain civilians serving in a qualified hazardous duty area in support of the U.S. Armed Forces, such as Red Cross personnel, accredited correspondents, and civilian personnel acting under the direction of the U.S. Armed Forces in support of those forces.

**2001
TAX
INFORMATION
SERIES**

**TAX TIPS FOR THE
NEWLY DIVORCED**

This pamphlet provides information concerning your federal income taxes. If you have legal questions concerning your taxes, and your unit tax advisor is unable to answer them, call the number below for an appointment to see a lawyer.

**LEGAL ASSISTANCE TELEPHONE
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OFFICE OF THE STAFF JUDGE ADVOCATE

TAX TIPS FOR THE NEWLY DIVORCED

DIVORCE CAUSES CHANGES IN YOUR TAX SITUATION. HERE ARE A FEW GENERAL GUIDELINES AND TAX TIPS:

Choose the correct filing status: Your marital status is important in determining your income tax filing status. You may file as "single" if you are unmarried and obtained your divorce, legal separation (determined under state law), or annulment by the end of your tax year (usually 31 December). You generally file as "head of household" if you are unmarried at the end of the tax year or are married and lived apart from your spouse the last six months of the tax year, and you kept up a home for your child (listing the child's name on the return) or, if you are unmarried, for the person whom you claim as a dependent. Couples not divorced by the end of the year may be able to file "jointly" (married filing jointly status) or separate returns (married filing separately). You should figure your tax both ways to make sure you are using the method that will result in the lower tax.

Exemption amount increased for 2001. You are allowed to deduct \$2,900 for yourself and each person you can claim as your dependent for the 2001 tax year. An exemption for your spouse is allowed only if you are married and file a joint return with your spouse, or if you file a separate return and the spouse had no gross income and was not a dependent on another person's return. You must list the social security number for any person for whom you claim and exemption.

Who gets to claim the kids? There are several tests a parent must meet to claim an exemption for a child when the parents file separately. A child's exemption usually may be claimed by one of the parents (not both) if the child had gross income of less than \$2,900 for 2001 or that child is under 19 or is a student under 24. Generally, the custodial parent gets to claim the child. If neither a divorce decree nor agreement establishes custody, then the parent who had physical custody for the greater part of the year is considered to have custody of the child. The custodial parent can release the exemption to the noncustodial parent by signing a written declaration, Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents, or similar statement.

Alimony is income for one--deductible by the other.

Alimony or separate maintenance payments you make to your spouse or ex-spouse under a divorce or separation agreement are tax deductible (they are an adjustment to your gross income reported on the Form 1040). You do not have to itemize deductions to claim alimony payments. The recipient of alimony payments reports them on the Form 1040 as part of the recipient's gross income. You do not deduct child support payments that you make. If you receive child support, it is not included in your gross income.

Legal fees you pay may include deductible and nondeductible charges. If you incur legal expenses in obtaining a divorce or separation, you should have your civilian attorney itemize the charges for his services. Legal fees and court costs for getting a divorce are not deductible. You may, however, deduct legal fees paid for tax advice in connection with the divorce, and legal fees to get alimony that you must include in your gross income. You may also include fees you pay to other professionals (e.g., appraisers, accountants) for services in determining the correct amount of your tax or in helping to obtain alimony. If you itemize deductions, you may claim the deductible charges, subject to the 2% of adjusted gross income floor.

Remember to change your tax withholding. You will usually have to file a new Form W-4, Employee's Withholding Allowance Certificate, with your employer when you become divorced or separated. Changes in income, deductions, exemptions, or filing status during the year may require you to change the amount of tax withheld or begin to make estimated tax payments. For instance, if you are single, divorced, or legally separated, you must claim single status on your Form W-4. If you receive alimony or other payments which are not subject to withholding, you may have to ask for additional withholding from your wages or make estimated tax payments.

See IRS Publication 504, Divorced or Separated Individuals, for more information. It contains specific details on the tax rules on property settlements, IRAs, and other topics of interest to divorced persons.

Important reminders. Notify the IRS of a change in your address using Form 8822, Change of Address. If you change your name, be sure to notify the Social Security Administration using Form SS-5, Application for a Social Security Card.

**2001
TAX
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**ELECTRONIC
FILING
INFORMATION**

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OFFICE OF THE STAFF JUDGE ADVOCATE

ELECTRONIC FILING INFORMATION

[Installation tax officers may use this page to insert information on local electronic filing availability, location, hours, and procedures. A suggested format follows.]

Electronic tax return filing provides a faster refund and is a free service provided by _____. You generally will receive your refund within 2 to 4 weeks after filing your return. The following returns can be filed electronically: Form 1040, Form 1040A, and Form 1040EZ.

Electronic filing uses automation to replace many manual steps needed to process paper returns. As a result, processing for electronic returns is faster and more accurate. However, errors on the return or problems with its transmission can delay processing. As with a paper return, you are responsible for making sure your return contains accurate information and is filed on time.

Refunds. You can have a refund check mailed to you, or you can elect to have your refund deposited directly to your savings or checking account. Make sure the "routing transit number" (RTN) of your financial institution contains 9 digits. Your return will be rejected if there are less than 9 digits. Once an electronic return has been accepted by the IRS, you cannot cancel the direct deposit election nor can you change your RTN or bank account number.

Free electronic filing services are available at:

**2001
TAX
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**DOCUMENTS
NEEDED FOR TAX
ASSISTANCE**

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OFFICE OF THE STAFF JUDGE ADVOCATE

DOCUMENTS NEEDED FOR TAX ASSISTANCE

Bring the following documents when you desire assistance in completing your federal income tax return:

IF YOU FILED A FORM 1040EZ LAST YEAR, bring:

1. Last year's federal income tax return;
2. Your W-2 (wage and earnings statement); and
3. Form 1099 (interest statements from banks).

IF YOU FILED A FORM 1040A LAST YEAR, bring:

1. Last year's federal income tax return;
2. Your W-2 (wage and earnings statement);
3. Form 1099 (interest statements from banks);
4. Social security numbers for all dependents you are claiming on this year's tax return;
5. Information on child care expenses you paid last year; and
6. Information on Individual Retirement Arrangements (IRAs) if you did or plan to contribute.

IF YOU FILED A FORM 1040 LAST YEAR, bring:

1. Last year's federal income tax return;
2. Your W-2 (wage and earnings statement);
3. Form 1099 (interest statements from banks);
4. Social security numbers for all dependents you are claiming on this year's tax return;
5. Information on child care expenses you paid last year;
6. Information on Individual Retirement Arrangements (IRAs) if you did or plan to contribute;
7. Mortgage interest statement (if any);
8. Alimony information (copy of divorce or separation agreement); and
9. Any other financial information from the tax year (e.g., investment statements, rental report, medical expenses, charitable contribution records).

SEE YOUR UNIT TAX ADVISOR FOR MORE INFORMATION & ASSISTANCE.

**2001
TAX
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**FEDERAL TAX
INFORMATION ON
COMMUNITY
PROPERTY**

This pamphlet provides information concerning your federal income taxes. If you have legal questions concerning your taxes, and your unit tax advisor is unable to answer them, call the number below for an appointment to see a lawyer.

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OFFICE OF THE STAFF JUDGE ADVOCATE

FEDERAL TAX INFORMATION ON COMMUNITY PROPERTY

GENERAL.

Federal income taxes are affected by community property laws if the taxpayers are married, live in a community property state, and are filing separate returns. In most cases, the tax will be less by filing a joint return if the taxpayers are married. Taxpayers domiciled (legal residence) in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, or Wisconsin may find the following information useful in determining their federal income tax liability.

COMMUNITY PROPERTY.

Community property is all property acquired by a husband, wife, or both of them, during their marriage while they are domiciled in a community property state. Community property does not include property acquired separately by gift or inheritance, or with separate funds. According to state law, each spouse owns an undivided half of all community property.

Community income.

Ordinarily, community income is all income from community property and salaries, wages, and other pay received during the marriage. In Idaho, Texas, and Wisconsin, income from most separate property is also treated as community income. State law determines community income.

The difference is important when the spouses file separate federal income tax returns. When they do so, each taxpayer

must report one-half of all community income. The income, expenses, deductions, exemptions, and credits each spouse may take must be identified and reported separately.

SEPARATE PROPERTY.

The taxpayer's domicile determines the property's ownership status. Separate property is all property owned separately by the spouses before the marriage, as well as money earned while domiciled in a noncommunity property state. It is also property a spouse acquired as a gift or inheritance. A spouse may also acquire separate property during a marriage by purchasing it with separate funds.

Separate income.

Income from separate property is usually income of the spouse who owns the separate property. However, in Idaho, Louisiana, Texas, and Wisconsin, income from most separate property is community income.

Deductions.

Expenses that are not attributable to any specific income, such as medical expenses, are deductible by the spouse who pays them. If these expenses are paid from community income, then the spouses split the deduction equally.

SPOUSES LIVING APART.

Married taxpayers who are community property state domiciliaries are subject to special rules if they have lived apart the entire year and meet all of these conditions:

The spouses do not file a joint return for the tax year;

One or both spouses have earned community income for the year; and

The spouses have not transferred, directly or indirectly, any of the earned income between themselves during the year. (Payments for child support are not considered.)

Taxpayers satisfying all of these conditions must report community income as explained below:

EARNED INCOME. Each spouse reports his own earned income (e.g., wages, salary, other compensation for personal services).

SEPARATE PROPERTY INCOME. The taxpayer-owner of the separate property reports his own property's income.

OTHER INCOME. Taxpayers treat other community income (e.g., dividends, interest, rent, royalties, or gains) as provided under the state community property laws.

Example: H and W were married throughout 2001, but did not live together at any time during the year. Both were domiciled in Texas, a community property state. They did not file a joint return or transfer any of their unearned income between themselves. 2001 incomes:

	<u>H</u>	<u>W</u>
Wages	\$20,000	\$22,000
Consulting business fees	5,000	
Dividends from separate property	1,000	2,000
Interest from community property	<u>500</u>	<u>500</u>
	\$26,500	\$24,500

Under Texas' community property laws, all of H's and W's income is community income. W did not take part in H's consulting business.

Ordinarily, H and W would each report one-half of the total community income $\$25,500 = [(\$26,500 + \$24,500) \div 2]$ on their separate federal return. Since they meet the conditions for spouses living apart, however, they must disregard the community property law in reporting all their income except the interest from community property.

OTHER SEPARATED SPOUSES. Community property domiciliary taxpayers, who are separated but do not meet the conditions discussed earlier, must treat income according to the laws of their

state. In some states, income earned after separation, but before a divorce decree is obtained, continues to be community income. In other states, it is separate income.

PREPARING A FEDERAL INCOME TAX RETURN.

Community property domiciliary taxpayers who file separate returns must each report half of the combined community income and deductions in addition to any separate income and deductions.

Taxpayers are encouraged to attach a worksheet showing the compilation of the one-half portions reported separately or attach a copy of the other taxpayer's return showing the division of income and withholding tax.

PERSONAL EXEMPTIONS AND DEPENDENTS. When filing separate returns, the taxpayer claims his own exemption (\$2,900 in 2001). The taxpayers cannot divide the allowed amount for dependents. Instead, community property domiciliary taxpayers divide the number of dependents in any manner desired.

Example: H supports W and three dependent children with community funds. If H and W file separate federal returns, only he may claim his own exemption, and only his wife may claim her own exemption. By agreement, H or W may split the three exemptions for the children with H getting one, two, or all three; W gets what H does not take.

CAUTION: Married parents in community property states who file separate returns where all the couple's income is community income may need to sign a Form 2120, MULTIPLE SUPPORT AGREEMENT, to ensure that one of them gets to claim the dependency exemption for children. This is because when there is only community income each parent on a separate return is treated as having provided exactly one-half of the child's support, regardless of who actually paid it. (NOTE: Form 2120 is not required where either parent can prove that he has separate (non-community) income; that parent may be able to satisfy the more-than-50% support test.)

Consult IRS Publication 555, Federal Tax Information on Community Property, for more information.

**2001
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**MINOR
CHILDREN'S TAX
ISSUES**

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MINOR CHILDREN'S TAX ISSUES

GENERAL.

Children under the age of 14 are taxed as single persons on their earned income and on their **unearned** income (investment income) of \$1,500 or less (IRC § 1(g)). No tax is imposed on the first \$750 of income because of the child's \$750 standard deduction. The second \$750 is taxed at the child's rate. The unearned income above \$1,500 of children under age 14 is taxed at the parents' highest marginal rate. A child's wages and salary are his earned income. Unearned income includes all income other than wages, salary, and other amounts received for work actually done. For example, interest, dividends, rents, royalties, capital gains, income earned in custodial accounts, and income from trusts are unearned income.

If the child's gross income was \$2,900 or more, the child usually cannot be claimed as a dependent, unless the child was under 19 (or under 24 if a student).

FILING A CHILD'S RETURN

The child's parents or guardian signs and files the child's return unless the minor is able to do so.

The dependent child must file a tax return if he had:

- 1) unearned income of more than \$750;
- 2) earned income was more than \$4,550; or
- 3) gross income (combined earned and unearned income) of more than the larger of \$750, or earned income (up to \$4,300) plus \$250.

Children under 14 at the end of 2001 with unearned income of \$1,500 or less follow the usual filing rules, filing either Form 1040EZ, Form 1040A, or Form 1040 as appropriate.

Once an under 14 child's unearned income exceeds \$1,500, the "kiddie tax" computation applies (unless neither parent is alive at the end of the child's tax year). Form 8615 must be filed with the child's return, unless the child's only income is interest and dividends and the parents elect to report those earnings on their return by filing Form 8814. When the child files his own return, the parents' top rate applies to net investment income (i.e., gross investment income minus \$1,500 if the child does not itemize). This means that the child's first \$1,500 of unearned income is exempt from the "kiddie tax" rules. The child's Form 8615 cannot be completed until the parents have determined their own taxable income which depends on their marital and filing status.

When the parents file jointly, their joint taxable income is entered on Form 8615 together with the net investment income of all their children under age 14.

When the parents file separately, the larger of the parents' separate taxable income is entered on Form 8615. A separate Form 8615 must be filed for each child.

Children over 14 at the end of 2000 file the appropriate form as for adult taxpayers without regard to the "kiddie tax" rules.

PERSONAL EXEMPTION.

Since 1987, anyone who can be claimed as a dependent on another person's tax return is not entitled to an exemption for himself (IRC § 151(d)(2)). This provision affects minor children, full-time students, and other adults who may be claimed as dependents. In the case of children, it has the effect of reducing the amount of income which can be sheltered from taxation. The value of each 2001 exemption is \$2,900.

STANDARD DEDUCTION.

Those taxpayers who have unearned income and can be claimed as a dependent by another taxpayer (again, this will usually be a dependent child) may have a limited standard deduction (IRC § 63(c)(5)). The limited standard deduction is not to exceed the greater of \$750 or the earned income of the dependent plus \$250, but not more than the regular standard deduction.

Even if a dependent child may not claim a personal exemption, the child may take a \$750 standard deduction in 2001. In other words, \$750 of unearned income may be offset by the zero bracket amount. That is, to the extent that compensation income is less than the standard deduction (\$4,550), that income is offset by a standard deduction amount equal to their compensation income. To the extent that compensation income is greater than the standard deduction, dependents may claim the full standard deduction (i.e., \$4,550 for single individuals). A child without unearned income can have employment income up to \$4,550 without incurring a tax liability.

UNEARNED INCOME.

Children under age 14 with more than \$750 of unearned income in excess of the \$750 standard deduction (or itemized deductions attributable to the unearned income) will be taxed at their parents' rates (IRC § 1(g)). Children who do not itemize deductions will have a \$750 standard deduction to be used against unearned income, and \$750 of unearned income will be taxed at the child's rate. Children who have more than \$750 of itemized deductions attributable to the unearned income may claim their itemized deductions. They will also be taxed on the next \$750 of unearned income at their own rates. The rate depends on whether the child has compensation income.

Any income above the amount taxed at the child's rate will be taxed at the greater of (1) the regular tax on the child's income or (2) the sum of the regular tax on the child's compensation income, plus the regular tax on \$750 of unearned income, plus the child's share of the "allocable parental tax." Because the 15% rate bracket and the personal exemptions are phased out by means of a 5% surcharge and because of differences between the single and married filing jointly or married filing separately tax tables, it will not always be easy to estimate whether the child's own rate or the child's tax combined with that of his parents will result in the higher tax.

To calculate the allocable parental tax, the parents must calculate their taxes twice: first, the regular way, and second, adding their children's net unearned income to their income. (Net unearned income is unearned income less both the standard deduction or itemized deductions and the \$750 taxed at the child's rate.) The difference between the tax on the two amounts is the allocable parental tax. That amount is allocated to each child of the parent in proportion to the amount of net unearned income of each child. For example, take a couple with three children, Ann, Brad, and Cathy, where Ann had net unearned income of \$1,000, Brad had \$2,000, and Cathy had \$3,000. Assuming the allocable parental tax was \$1,650 (28% of \$6,000), Ann would pay \$275, Brad would pay \$550, and Cathy would pay \$825. Even though it is computed by reference to the parents' income, the allocable parental tax is the obligation of the child. This additional tax is computed on Form 8615, COMPUTATION OF TAX FOR CHILDREN UNDER 14 WHO HAVE INVESTMENT INCOME OF MORE THAN \$1,500.

When the parents are computing the allocable parental tax, the net unearned income of the children is not taken into account in computing any deductions or credits of the parent. This means that the 7.5% floor on medical expense deductions, the 2% floor on miscellaneous itemized deductions, and the maximum limit on charitable contributions will not be adjusted in computing the parental tax the second time (Treas. Temp. Reg. § 1.1(i)-1T (Q and A21)).

If the parents file separate returns, the allocable parental tax will be calculated using the income of the parent with the higher taxable income. If the parents are not married, the allocable parental tax is calculated using the income of the custodial parent. Where parents are legally separated or divorced and custody of the child is shared, the taxable income of the parent with custody for most of the year is used to complete the Form 8615.

Parents of children who must pay a share of the allocable parental tax are required to furnish their children with the parents' taxpayer identification numbers (social security numbers), and the children are required to show those numbers on their tax returns. Presumably, the parents of any child required to pay the allocable parental tax will be calculating the taxes owed by the child. The parents will have access to the parental income figures necessary to calculate the child's share of the allocable parental tax; but if the parents do not calculate the child's taxes or provide the child with the necessary information, any child or child's legal representative may request the IRS to disclose or permit inspection of the parents' tax return to the extent necessary to comply with the allocable parental tax provisions.

Parental Election to Report Child's Interest and Dividend Income on Parents' Return:

The parent whose taxable income is used in computing the child's share of the allocable tax may elect to include the child's income on the parents' return without filing a separate return for the child. Under this election, the child is treated as if he had no income. Form 8814, filed with the parents' return, is used to make this election. The parent(s) may make this election only if--

- your child was under age 14 on 1 January
- the child's income consists solely of interest and dividends,
- the child's interest and dividends are less than \$7,500,
- there were no estimated tax payments for the child during the year, and
- the child was not subject to backup withholding last year.

Parents making the election and completing Form 8814 include in their income the child's interest and dividends to the extent it exceeds \$1,500, plus 10% of the lesser of \$750 or the excess of the child's income over \$750.

Other than avoiding filing a return for the child, there is no apparent advantage to making the election and filing Form 8814. **On the other hand, by filing the Form 8814, the child's income is included in the parents' AGI affecting the floor and ceiling for certain adjustments to income and itemized deductions.**

TAX PLANNING AROUND THE KIDDIE TAX. Parents should remember that a child under age 14 must have net unearned income of \$1,500 before the kiddie tax is triggered. Consequently, parents can accumulate a substantial amount in the child's name before the kiddie tax applies. Moreover, investing the child's funds in assets that do not produce unearned income currently (e.g., growth mutual funds or stocks which pay small, if any, dividends) effectively avoids triggering the kiddie tax.

U.S. Government Series EE Savings Bonds also may be suitable for children at any age. Savings Bonds are sold at 50% of their face value. Federal income tax need not be paid on the interest these Bonds earn until they are redeemed. Parents purchasing Series EE Bonds in the child's name for eventual use to pay college education costs should consider the IRC § 135 interest exclusion provisions. In certain circumstances (explained below), the interest on qualified U.S. Savings Bonds issued after 1989 is entirely free from federal tax if used to pay for higher education costs.

There are four basic restrictions to the qualified Savings Bond exclusion program.

First, the exclusion is available only for Bonds purchased on or after January 1, 1990. Bonds purchased before this date will not qualify. **Second**, the Bond must be issued to an individual who is at least 24 years old. Thus, a parent or grandparent must own the Bond; and if it later turns out that the Bonds will not be used for college expenses, the accrued interest will be

taxed to that individual. **Third**, the exclusion is phased out as the adjusted gross income of the taxpayer exceeds certain levels depending on the Bond owner's filing status. The **final requirement** is that the amount of the interest on the redeemed Bonds must be lower than the qualified higher educational expenses of the child, the taxpayer, or a spouse. Educational costs are broadly defined as including tuition and fees, but do not include room and board. (Note: As a result of the Taxpayer Relief Act of 1997, educational expenses will also include room and board.)

High bracket taxpayers who have AGI above the limits to take full advantage of the tuition payment program may consider purchasing the Bonds in the child's name and have the child elect to pay tax on the interest each year, instead of waiting until the Bonds are redeemed. Each year's taxable interest will be sheltered from income tax by the child's yearly standard deduction.

Refer to IRS Publication 929, Tax Rules for Children and Dependents, for additional information and examples of completed Forms 8814 and 8615.

**2001
TAX
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**OFFER IN COMPROMISE
FOR TAXPAYERS FACING
ECONOMIC HARDSHIP**

This pamphlet provides information concerning your federal income taxes. If you have legal questions concerning your taxes, and your unit tax advisor is unable to answer them, call the number below for an appointment to see a lawyer.

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OFFICE OF THE STAFF JUDGE ADVOCATE

NEW OFFER IN COMPROMISE APPLICATIONS BEING ACCEPTED FOR TAXPAYERS FACING ECONOMIC HARDSHIPS

The Internal Revenue Service is accepting applications for a new type of Offer in Compromise plan designed to help some taxpayers facing severe or unusual economic hardships. For the first time, the IRS will be able to consider economic hardship factors in cases where taxpayers try to settle unpaid tax debts through the Offer in Compromise program and where settlement would promote effective tax administration. "This program creates a new way for the IRS to help some people trapped in severe hardships," IRS Commissioner Charles O. Rossotti said. "We have more power to work with struggling taxpayers trying to settle their tax debt."

The change expands the Offer in Compromise program, which allows the IRS to negotiate a settlement with people unable to pay their entire tax bill. Previously, the IRS could accept the taxpayer's Offer in Compromise only when there was doubt about whether the tax debt could ever be collected or whether it was owed. The IRS Restructuring and Reform Act approved last year by Congress and President Clinton called for expanding the Offer in Compromise program as part of a new set of taxpayer rights provisions. The new category of Offer in Compromise can be used in cases where acceptance of the offer would promote effective tax administration and would not undermine compliance with the tax laws. Taxpayers may be eligible for this new provision if collection of the entire tax liability would create economic hardship, or Exceptional circumstances exist where collection of the entire tax liability would be detrimental to voluntary compliance. To qualify, taxpayers must have a history of paying and filing their taxes. To apply for this new way of settling tax debts, taxpayers can obtain a copy of Form 656-A through the IRS web site at www.irs.gov. The new form can be found by going to the "Forms and Pubs" section and looking under "Forms and Instructions."

Applicants will also need to submit a copy of Form 656, the standard Offer in Compromise application. Taxpayers applying for the new economic provision will be considered first under one of the traditional Offer in Compromise options. If the taxpayer is not eligible for a traditional Offer in Compromise, then the IRS will consider the application under the new economic hardship guidelines. "With this new program, we'll be able to help some people we couldn't help before," Rossotti said. The IRS cautioned the new program is designed only for taxpayers entangled in very severe circumstances. It's not designed to be a sweeping program for everyone with financial problems, and it shouldn't be viewed as an invitation to avoid paying taxes. What the new provision reflects is a commitment by the IRS to expand access to the Offer in Compromise program. To help taxpayers, the IRS moved earlier this year to create more straightforward rules, allow greater flexibility by essential agency employees and add new payment procedures for the Offer in Compromise program. "In the end, this helps all taxpayers," Rossotti said. "Instead of collecting nothing from people with an unpaid tax bill, we're able to collect something."

IRS TO HELP TAXPAYERS FACING ECONOMIC HARDSHIPS

SETTLE TAX DEBTS WITH NEW OFFER IN COMPROMISE PLAN

Some taxpayers facing severe or unusual economic hardships will have a new way of settling their tax debts under an Internal Revenue Service plan announced Monday. Under new regulations, the IRS for the first time will be allowed to consider economic hardship factors in cases where taxpayers try to settle unpaid tax debts through the Offer in Compromise program and where settlement would promote effective tax administration. "For taxpayers caught in severe hardships, this gives the IRS a new tool to work with people and help settle their tax debt," IRS Commissioner Charles O. Rossotti said. This change expands the Offer in Compromise program, which allows the IRS to negotiate a settlement with people unable to pay their entire tax bill. Prior to the new regulations, the IRS could accept the taxpayer's Offer in Compromise only when there was doubt about the whether the tax debt could ever be collected or whether it was owed. The IRS has already put in place changes that make it easier for taxpayers to apply for a compromise under existing regulations. The IRS Restructuring and Reform Act approved last year by Congress and President Clinton called for expanding the Offer in Compromise program as part of a new set of taxpayer rights provisions. The provision outlined in the temporary regulations (TD 8829) creates a new category of Offer in Compromise to resolve cases where acceptance of the offer would promote effective tax administration. Under this new provision, taxpayers may be eligible for a compromise if: Collection of the entire tax liability would create economic hardship, or Exceptional circumstances exist where collection of the entire tax liability would be detrimental to voluntary compliance.

According to the regulations, an Offer in Compromise cannot be approved in situations where it would undermine compliance with the tax laws. To qualify, taxpayers also must have a history of paying and filing their taxes. "This new type of offer gives the IRS a safety valve to handle tax cases in difficult situations," Rossotti said. "We now have more flexibility to settle debts with taxpayers in ways we couldn't before." The temporary regulations outline several possible examples where taxpayers might qualify for the new type of Offer in Compromise: Economic hardship can include taxpayers - and their dependents -facing a long-term illness, medical condition or disability where the person's financial resources will be exhausted while providing for care and support. An example can include a parent who has assets large enough to pay the tax bill, but those assets will be needed for care of a child with a long-term illness. Economic hardship can also cover cases where the sale or liquidation of assets to pay the tax bill would prevent the taxpayer from meeting basic living expenses. An example could be a retiree with a retirement fund large enough to pay the tax bill, but using the fund would deprive the person of basic living expenses. In the second area, an Offer in Compromise may be granted under exceptional circumstances, such as extraordinary events beyond a taxpayer's control. An example might include someone who was hospitalized for several years, could not manage any financial affairs and was unable to file tax returns. Rossotti said the new compromise offer strikes a balance between helping individual taxpayers in severe circumstances and protecting all taxpayers by collecting as much of the tax bill as possible. "Ultimately, this program will help all taxpayers," Rossotti said. "Instead of collecting nothing from taxpayers with an unpaid tax

bill, we're able to collect something and resolve the case. And it gives people in dire financial situations a way of satisfying their tax obligations."

The IRS cautioned the new program is tailored only for taxpayers entangled in very severe circumstances, and it's not designed to be a sweeping program for everyone with financial difficulties or a panacea for people with tax problems. "This will help some people in trouble that we haven't been able to help before," Rossotti said. "But it shouldn't be misinterpreted by people as an open invitation to avoid paying taxes. The IRS anticipates implementing the temporary regulations and beginning to process applications within 60 days. This will give the IRS enough time to finalize new procedures, print new forms and train Collection employees on the new guidelines. The IRS also is nearing completion on a new application for the special Offers in Compromise category, which will be Form 656-A. This new form will be submitted in addition to Form 656, the standard Offer in Compromise application. When the taxpayer submits new 656-A applications, the IRS must first determine whether a taxpayer is eligible for one of the traditional Offer in Compromise options. If the taxpayer is not, then the agency will consider the application under the new economic hardship provisions. The temporary regulations issued this week will be in effect for three years, which will give the IRS an opportunity to monitor the program's progress and get feedback from tax practitioners and others. "This will give us the chance to fine tune the program in the future," Rossotti said. In fiscal year 1998, the IRS accepted 25,052 Offers in Compromise, leading to the collection of \$290 million out of \$1.9 billion in outstanding tax bills. Earlier this year, the IRS took several steps to expand access to the Offer in Compromise program. To help taxpayers, the IRS program now features more straightforward rules, increased flexibility by key agency employees, new payment procedures and a new review process for rejected offers. "There is a delicate balance to this program," Rossotti said. "We have to carefully balance the rights of individual taxpayers with the rights of all taxpayers. The goal is to be fair to everyone."

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**NEW INSTALLMENT
AGREEMENT AID ON IRS
WEB SITE**

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OFFICE OF THE STAFF JUDGE ADVOCATE

NEW INSTALLMENT AGREEMENT AID ON IRS WEB SITE

The Internal Revenue Service has a new aid for those interested in paying their taxes on an installment plan. Its Web site now has an interactive calculator that helps a person figure the monthly payment amount, and then prints out an installment agreement form for the taxpayer to file. "This is yet another way we're improving our services and helping people meet their tax obligations," said IRS Commissioner Charles O. Rossotti. "We should have less need to ask taxpayers for additional information, thus speeding our review process for their installment requests." The calculator is for individuals who have filed their returns and are not already paying taxes under an installment agreement. It is available through the "Interactive Installment Payment Process" link on the "Tax Info for You" page of the IRS Web site, www.irs.ustreas.gov. Those qualifying for a "streamlined" agreement -- generally, taxpayers with a tax debt of not more than \$25,000 that they will be able to pay off within five years -- will find out how long their proposed monthly payments would last. Taxpayers who do not meet the criteria for a streamlined agreement can compare their monthly expenses to the amounts allowed under the IRS's Collection Financial Standards, to help determine an appropriate tax payment amount. Users may print out the Form 9465, Installment Agreement Request, from the Web site -- with the allowable expense worksheet, if used -- and mail it to the IRS for review and approval. The Web site does not store or transmit any personal data. Persons who are already paying back taxes under an installment plan must pay all subsequent taxes on time or they will default on their agreement. Taxpayers with an installment agreement who are unable to make a future tax payment should call the IRS at 1-800-829-1040 for assistance.

IRS Interactive Calculator found at: http://www.irs.ustreas.gov/prod/ind_info/coll_stds/collect.html.

**2001
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**TAX TIPS FOR LAST-
MINUTE FILERS**

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OFFICE OF THE STAFF JUDGE ADVOCATE

TAX TIPS FOR LAST-MINUTE FILERS

With the tax filing deadline at fast approaching, the Internal Revenue Service offered some tips for those still working on their tax forms:

- Put your social security number on the return -- it's no longer on the label.
- Double-check your figures.
- Sign your form.
- Attach all required schedules-and send your return or extension request to the IRS by April 15.

As usual, most people will not need this last-minute advice, because they have already filed. Perhaps the most notable trend this year has been the strong growth in e-filing. The numbers to check most carefully on the tax return are the identification numbers -- usually social security numbers (SSNs) -- for each person listed. This includes the taxpayer, spouse, dependents, and persons listed in relation to claims for the child care or earned income tax credits. Missing or incorrect SSNs can delay or reduce a tax refund. Taxpayers should also check that they have correctly figured the refund or balance due and have taken the right amount from the tax table. The child tax credit is up to \$600 for each eligible dependent under age 17. The total credit phases out as a person's income rises above \$75,000 (\$110,000 on a joint return). Taxpayers eligible for this credit should both check the qualifying child box on line 6c of the return and enter the credit amount on line 43 (line 28 on Form 1040A).

Two other new tax credits are based on tuition and fees paid for higher education. The Hope credit is for the first two years of college only. The lifetime learning credit is for any postsecondary education, but only for payments and courses after June 1998. The education credits are not available for taxpayers with incomes above \$50,000 (\$100,000 for joint returns), or for taxpayers whose filing status is married filing separately. An education credit may be claimed only by the person who claims the student as a dependent, or by the student if no one claims him or her as a dependent, regardless of who actually paid the qualified expenses. Taxpayers must sign and date their returns. Both spouses must sign a joint return, even if only one had income. Anyone who is paid to prepare a return must also sign it. The only attachments that should be at the front of the tax return are Form W-2 wage statements, Form W-2G reports of gambling winnings, Form 1099-R pension or annuity statements showing tax withheld, or Form 9465, requesting an installment payment plan. All other required forms and schedules should be behind the Form 1040 or 1040A, in the attachment sequence order listed in the upper right corner of each page. People sending payments should make the checks out to "United States Treasury" and should not attach the check to the tax return or to the Form 1040-V payment voucher, if used. The check should include the taxpayer's social security number, daytime phone number, the tax year and the type of form filed. Taxpayers should file a return or a Form 4868, to request a four-month extension, by April 15. Those who don't e-file may use the U.S. Postal Service or one of the designated private delivery services. The tax instructions list these private delivery services, which are offered by four companies: Airborne Express, DHL Worldwide Express, Federal Express and United Parcel Service. The IRS tax help number -- 1-800-829-1040 -- is open 24 hours a day, seven days a week.

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**TAX DEADLINE NEARS –
EXTENSIONS EASILY
AVAILABLE**

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OFFICE OF THE STAFF JUDGE ADVOCATE

TAX DEADLINE NEARS -- EXTENSIONS EASILY AVAILABLE

Taxpayers can get an extra four months to file by sending Form 4868, "Application for Automatic Extension of Time To File U.S. Individual Income Tax Return," to the IRS by April 15. Taxpayers who live outside the U.S. and Puerto Rico and whose main place of work is outside the U.S. and Puerto Rico already have an extension to June 15. This also applies to those in military service outside the country. Taxpayers with this June deadline can use Form 4868 to get an additional two months to file. Merely being outside the U.S. on April 15 does not extend a taxpayer's deadline to June 15. You must estimate your total tax liability based on the information you have when requesting the extension. If the IRS later finds this estimate to be unreasonable, your extension will be null and void. A filing extension does not give you more time to pay any taxes owed. You may pay any projected balance due with the Form 4868, but if you can't pay the full amount, you can still get the extension. Interest charges apply to any tax not paid by April 15. The current rate is eight percent a year, compounded daily, and is subject to change each calendar quarter. You may also be liable for a late payment penalty of 0.5 percent per month if the total you have paid by April 15 is less than 90 percent of your actual tax. Form 4868 is available from the IRS Web site at www.irs.ustreas.gov. Those with a fax machine may use the IRS TaxFax by calling 703-368-9694 and request Item #13141 by return fax. Form 4868 is also available at local Tax Assistance Offices, Legal Assistance Offices, IRS offices and many public libraries.

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**STATE INCOME
TAX WEB SITES**

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State Income Tax Web Sites*

Check the IRS web site for other or updated state tax links.

http://www.irs.ustreas.gov/prod/forms_pubs/ftaframes.html

State Name	Official Website Address (Main Page for Tax Divisions)	E-mail Address for Tax Questions
Alabama	http://www.ador.state.al.us/	ero.helpdesk@revnue.state.al.us
Arizona	http://www.revenue.state.az.us/	no e-mail available yet
Arkansas	http://www.state.ar.us/dfa/taxes/index.html	no e-mail available yet
California	http://www.ftb.ca.gov/	Contact through web site
Colorado	http://www.state.co.us/taxes/	revenue@spike.dor.state.co.us
Connecticut	http://www.state.ct.us/drs/	drs@po.state.ct.us
Delaware	http://www.state.de.us/revenue	personaltax@state.de.us
District of Columbia	http://www.dccfo.com/	no e-mail help available yet
Georgia	http://www.state.ga.us/departments/dor/	inctax@rev.state.ga.us
Hawaii	http://www.state.hi.us/tax/tax.html	no e-mail help available yet
Idaho	http://www.state.id.us/tax/index.html	taxrep@tax.state.id.us
**Illinois	http://www.revenue.state.il.us/	shoff@revenue.state.il.us
Indiana	http://www.state.in.us/dor/	amorgan@dor.state.in.us
Iowa	http://www.state.ia.us/government/dr/	iadrf@iadrf.e-mail.com
Kansas	http://www.ksrevenue.org/	Kdor141@ink.org
Kentucky	http://revenue.state.ky.us/	PGAY@mail.state.ky.us
Louisiana	http://www.rev.state.la.us/	webmaster@rev.state.la.us
Maine	http://www.state.me.us/revenue/	income estate_tax@state.me.us
Maryland	http://www.comp.state.md.us/	taxhelp@comp.state.md.us
Massachusetts	http://www.state.ma.us/dor/	dortsd@shore.net
**Michigan	www.treas.state.mi.us	treasindtax@state.mi.us
Minnesota	www.taxes.state.mn.us	DORweb.comm@mail.state.mn.us
Mississippi	www.mstc.state.ms.us/index2.htm	webmaster@mstc.state.ms.us
Missouri	http://dor.state.mo.us/	dormail@mail.state.mo.us
Montana	www.state.mt.us/revenue/	calexander@state.mt.us
Nebraska	www.nol.org/home/NDR/	access e-mail through website
New Jersey	www.state.nj.us/treasury/taxation/	taxation@oit.state.nj.us
New Mexico	www.state.nm.us/tax/	poffice@state.nm.us

New York	www.tax.state.ny.us	Web_Master@tax.state.ny.us
North Carolina	www.dor.state.nc.us/DOR/	dscdor@ncdial.net
North Dakota	www.state.nd.us/taxdpt	tax@pioneer.state.nd.us
Ohio	www.state.oh.us/tax/	access through web site
Oklahoma	www.oktax.state.ok.us/	helpmaster@oktax.state.ok.us
Oregon	www.dor.state.or.us	no e-mail questions accepted
Pennsylvania	www.revenue.state.pa.us	parev@revenue.state.pa.us
Rhode Island	www.tax.state.ri.us/	mcanole@state.ri.us
South Carolina	www.dor.state.sc.us	Webmaster@dor.state.sc.us
Utah	www.tax.ex.state.ut.us/	taxmaster@tax.state.ut.us
Vermont	www.state.vt.us/tax/	vttaxdept@tax.state.vt.us
Virginia	www.state.va.us/tax/	taxes@state.va.us
West Virginia	www.state.wv.us/taxdiv/	No e-mail help available
Wisconsin	www.dor.state.wi.us	income@mail.state.wi.us <i>States of Alaska, Florida, Nevada, Tennessee, Texas, Washington and Wyoming do not levy personal income tax on wages and salaries earned.</i>

**Michigan and Illinois do not tax military pay (or retired military pay).

**2001
TAX
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**TAX & WAGE
STATEMENTS FOR DOD
PERSONNEL**

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OFFICE OF THE STAFF JUDGE ADVOCATE

TAX AND WAGE STATEMENTS FOR DOD PERSONNEL

2000 Federal tax and wage statements for DoD personnel:

SERVICE MEMBERS who have not received their 2001 Federal Tax and Wage Statements (Form W-2) by the end of January, or those who think they need corrections to their W-2s, should contact their local finance offices. If the finance offices cannot help, contact:

ARMY

Active Duty 1-888-729-2769 (PAYARMY)

Reserve 1-888-729-2769 (PAYARMY)

CIVILIAN EMPLOYEES should contact their local Customer Service Representative.

MILITARY RETIREES who do not receive IRS Form 1099R (Distributions From Pensions, Annuities, Etc.) should call 1-800-321-1080. Due to the anticipated high volume of requests from retirees who may have relocated during the year, retirees may experience short waits before customer service personnel can respond to incoming calls.

ANNUITANTS who do not receive IRS Form 1099R (Distributions From Pensions, Annuities, Etc.) should request a form through the automated system at 1-800-435-3396.

**2001
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TAX PAYMENT OPTIONS

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OFFICE OF THE STAFF JUDGE ADVOCATE

NEW TAX PAYMENT OPTIONS & EASIER INSTALLMENT AGREEMENTS

Taxpayers who face a different type of “pay” day on April 15 have some new electronic options this year, and those seeking installment plans will benefit from the Internal Revenue Service’s streamlined approval process. Taxpayers who e-file by computer may authorize the government’s financial agents to take the money directly from their checking or savings account.

This is similar to direct debit arrangements many people have for their monthly mortgage, auto, utility or insurance payments, except it is for a single transaction. There is no charge for this service. Another innovation this year allows taxpayers to charge the balance due on a credit card. Any person may call toll-free to 1-888-2PAY-TAX to charge federal income tax to a MasterCard, Discover, or American Express card. Only the taxes may be charged, not estimated taxes. Taxpayers who use Intuit tax preparation software to e-file from home may pay the balance due by including their Discover Card number as part of the electronic file they send. Under both the phone and computer methods, private sector companies process the credit card transactions and the users pay convenience fees. The IRS is not involved in setting or collecting the fees. The cardholder’s account statement will show tax payments and fees separately.

Taxpayers who cannot pay the full tax due may set up an installment payment plan with the IRS. Congress gave taxpayers a right to an installment agreement, provided certain conditions are met, including that the tax owed is not more than \$10,000 and the taxpayer will pay it within a three-year period. The IRS went beyond these limits in recently streamlining its approval process for installment agreements. The IRS will now grant installments to taxpayers who agree to pay a balance due of \$25,000 or less within a five-year period. These agreements do not require a collection manager’s approval, and do not involve the filing of liens. Taxpayers may make these agreements in person, by phone, or by correspondence. This streamlined process applies to both individual and business income taxes, and to any type of tax for a business that is no longer operating. Instead of waiting for a contact from an IRS collector, taxpayers may ask for an installment plan when they file their returns. They should attach Form 9465, “Installment Agreement Request,” to the front of the tax return, listing the proposed monthly payment amount and the day. They may also choose to have the payments taken automatically from their bank account. The IRS will generally let them know within 30 days if the proposal is accepted. Form 9465 is available from the IRS Web site at www.irs.ustreas.gov, by calling (toll-free) 1-800-TAX-FORM, or from IRS TaxFax. From a fax machine, call 703-368- 9694 -- not a toll-free number -- and request item #14842 by return fax. There is a \$43 fee for setting up the installment agreement.

Taxpayers on an installment agreement will also pay interest -- currently figured at eight percent per year, compounded daily -- plus a monthly late payment charge of 0.5 percent of the balance due. After 1999, this monthly penalty drops to 0.25 percent for taxpayers with an installment agreement, provided they had filed the return on time and did not receive a notice that the IRS intended to enforce collection through a levy. Besides possibly qualifying for this reduced late payment penalty, people who cannot pay the taxes owed have another good reason to file their returns on time -- to avoid the late filing penalty of five percent per month of the balance due. Sending as large a payment as possible with the return will lessen any interest and

penalty charges. Taxpayers should make checks payable to "United States Treasury" and should include their name, address, Social Security number, a daytime phone number, the tax year and the form filed. They should not attach the checks to the tax forms, and should send any estimated tax payments separately.

**2001
TAX
INFORMATION
SERIES**

**FILL-IN FORMS
AVAILABLE ON IRS WEB
SITE**

This pamphlet provides information concerning your federal income taxes. If you have legal questions concerning your taxes, and your unit tax advisor is unable to answer them, call the number below for an appointment to see a lawyer.

**LEGAL ASSISTANCE TELEPHONE
NUMBER**

OFFICE OF THE STAFF JUDGE ADVOCATE

Fill-in Forms Instructions

(http://www.irs.gov/forms_pubs/fillin.html)

Overview

IRS fill-in forms use the features provided with Acrobat 3.0 products. Currently, there is no computation, validation or verification of the information you enter and you are still responsible for entering all required information (instructions may require some information to be handwritten on the form).

Software Requirements

To view, complete and print IRS fill-in forms you'll need the freely available <http://www.adobe.com/prodindex/acrobat/readstep.html> (or later) software installed on your computer.

Acrobat Reader does not allow you to save your completed forms to disk. The ability to save completed forms is available commercially with the Adobe Acrobat 3.0 (or later) product suite.

Completing the Form

- Download the form by following the instructions on the Fill-in Forms selection page. Your web browser may be configured with an Acrobat plug-in to automatically open the file within your browsers window upon download. To download the file directly to disk, right click on the Results Page form title link then select "Save Target/Link As.." when presented with a menu.
- Use Acrobat 3.0 to open the file if necessary.
- Select the hand tool from the Acrobat toolbar menu. You can use the hand tool to move the page around so that you can view all the areas on it.
- Position the hand pointer inside a form field and click. The I-beam pointer allows you to type text. The arrow pointer allows you to select a field, a check box, a radio button, or an item from a list.
- Press Tab to accept the field change and go to the next field.
- Press Shift + Tab to accept the field change and go to the previous field.
- Use your mouse to select an area of the form that is not inside a form field before printing your form. **If a form field is active (contains the blinking bar) the contents will not print.**
- If the fill-in form is displayed within your web browsers window be sure to use the printer button on the Acrobat toolbar menu to print the form instead of your web browsers print function.

**2001
TAX
INFORMATION
SERIES**

**ASSISTANCE FROM THE
IRS IN DEALING WITH
TAX PROBLEMS**

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**LEGAL ASSISTANCE TELEPHONE
NUMBER**

OFFICE OF THE STAFF JUDGE ADVOCATE

Tax Info for You

Here you will find information about how to get assistance if you are experiencing a problem dealing with the IRS or if you are suffering a significant hardship as a result of the administration of the tax law. You will also find information about your rights as a taxpayer.

Taxpayer Advocate

The Office of the Taxpayer Advocate administers the IRS' Problem Resolution Program (PRP) and is responsible for representing the taxpayers' point-of-view within the Service. Through annual reports to Congress, the Taxpayer Advocate identifies the most significant problems taxpayers are experiencing and what the IRS is doing to correct them. The Taxpayer Advocate is also responsible for recommending systems improvements and legislative proposals to improve services and reduce burden for taxpayers.

Problem Resolution Program (PRP)

PRP provides assistance to taxpayers whose problems are not resolved through normal IRS channels. Each IRS district and service center has a Problem Resolution office and a local Taxpayer Advocate. If you have a problem that hasn't been resolved in prior contacts with the IRS, you may call at 877-777-4778 or use the and write or visit the PRP office closest to you.

Are You Suffering a Hardship?

If you are suffering significant hardship as a result of the administration of tax law, you may file a, *Application for Taxpayer Assistance Order*, at the address shown in the Taxpayer Assistance Orders allow the Taxpayer Advocate to intervene, review the facts and circumstances of the case, and take appropriate steps allowed by law to relieve the taxpayer's hardship. A significant hardship is a situation where an action by the IRS, if taken, would prevent a taxpayer from providing for basic necessities such as housing, food, utilities, and transportation, or for a business taxpayer to meet basic expenses such as payroll.

Expansion of Taxpayer Advocate's Authority to Issue Taxpayer Assistance Orders

Public Law 105-206, IRS Restructuring and Reform Act of 1998, Section 1102, enacted July 22, 1998, significantly expanded the National Taxpayer Advocate's authority to issue Taxpayer Assistance Orders. The portion of Section 1102, which explains the new authority, is available for you to review.

Your Rights as a Taxpayer

You have rights as a taxpayer when dealing with the IRS. Both Congress and the IRS have addressed the issue of your rights, as explained in the following documents, available for you to download and read:

- **The Taxpayer Bill of Rights 2 (TBOR2)** - was passed by the 104th Congress and signed into law July 30, 1996. A copy of the Bill passed by Congress, is available on the IRS Website for you to download and read.
 - **Taxpayer Bill of Rights II**, is a training publication designed to provide a general overview of the provisions contained in TBOR2.
 - **Your Rights as a Taxpayer**, <http://ftp.fedworld.gov/pub/irs-pdf/p1.pdf> - is an IRS publication that explains your rights as a taxpayer.
-

Reports to Congress

TBOR2 requires the Taxpayer Advocate to submit two reports to Congress each year.

- The first report, delivered each June, contains the goals and activities planned by the Taxpayer Advocate for the coming year.
 - The second report, delivered at the end of December, is more substantial in content and importance, containing:
 - A summary of the 20 most serious problems encountered by taxpayers;
 - Recommendations for solving those problems; and
 - Other IRS efforts to improve customer service and reduce taxpayer burden.
 - The reports and other documents currently available for you to download and read on the IRS Website.
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**2001
TAX
INFORMATION
SERIES**

**INNOCENT SPOUSE
RELIEF
QUESTIONS & ANSWERS**

This pamphlet provides information concerning your federal income taxes. If you have legal questions concerning your taxes, and your unit tax advisor is unable to answer them, call the number below for an appointment to see a lawyer.

**LEGAL ASSISTANCE TELEPHONE
NUMBER**

OFFICE OF THE STAFF JUDGE ADVOCATE

Innocent Spouse Relief Questions and Answers

Q. What is the effective date of the new innocent spouse rules under IRC 6015?

A. IRC 6015 innocent spouse rules are effective for:

- Unpaid balances as of July 22, 1998; and
- Liabilities arising after July 22, 1998

Q. What is joint and several liability?

A. Many married taxpayers choose to file a joint tax return because of certain benefits this filing status allows. Both taxpayers are jointly and individually responsible for the tax and any interest or penalty due on the joint return even if they later divorce. This is true even if a divorce decree states that a former spouse will be responsible for any amounts due on previously filed joint returns. One spouse may be held responsible for all the tax due.

Q. How can I get relief from joint and several liability?

A. Relief now falls into three categories: Innocent Spouse Relief; Separation of Liability; and Equitable Relief. Each of these kinds of relief has different requirements. They are explained separately below.

Q. Can both spouses request relief?

A. Yes, each spouse can file a Form 8857 to request relief from liability from tax, interest and penalties.

Q. Does the non-requesting spouse have any appeal rights?

A. The non-requesting spouse has no appeal rights, unless that spouse files his/her own claim. If relief is denied and the requesting spouse petitions the U.S. Tax Court, the non-requesting spouse, by law, will be given the opportunity to be a party in that proceeding.

Q. Will the other spouse be notified that I filed a claim for innocent spouse relief?

A. The IRS is required to notify the non-requesting spouse to allow them to participate. They will also be notified of the determination on your election although they cannot protest it.

Q. What are the rules for Innocent Spouse Relief?

A. To qualify for innocent spouse relief, you must meet all of the following conditions:

- You must have filed a joint return which has an understatement of tax;
- The understatement of tax must be due to erroneous items of your spouse;
- You must establish that at the time you signed the joint return, you did not know, and had no reason to know, that there was an understatement of tax;
- Taking into account all of the facts and circumstances, it would be unfair to hold you liable for the understatement of tax; and
- You must request relief within 2 years after the date on which the IRS first began collection activity against you after July 22, 1998

Q. What are erroneous items?

A. Erroneous items are any deductions, credits, or bases that are incorrectly stated on the return, and any income that is not reported on the return.

Q. What is an understatement of tax?

A. An understatement of tax is generally the difference between the total amount of tax that should have been shown on your return and the amount of tax that was actually shown on your return. For example, you reported total tax on your 1996 return of \$2,500. IRS determined in an audit of your 1996 return that the total tax should be \$3,000. You have a \$500 understatement of tax.

Q. Will I qualify for innocent spouse relief in any situation where there is an understatement of tax?

A. No. There are many situations in which you may owe tax that is related to your spouse, but not be eligible for innocent spouse relief. For example, you and your spouse file a joint return that reports \$10,000 of income and deductions, but you knew that your spouse was not reporting \$5,000 of dividends. You are not eligible for innocent spouse relief when you have knowledge of the understatement.

Q. What are the rules for Separation of Liability?

A. Under this type of relief, you divide (separate) the understatement of tax (plus interest and penalties) on your joint return between you and your spouse. The understatement of tax allocated to you is generally the amount of income and deductions attributable to your earnings and assets. To qualify for separate liability, you must have filed a joint return and meet either of the following requirements at the time you file Form 8857:

- You are no longer married to, or are legally separated from, the spouse with whom you filed the joint return for which you are requesting relief. (Under this rule, you are no longer married if you are widowed.)
- You were not a member of the same household as the spouse with whom you filed the joint return at any time during the 12 month period ending on the date you file Form 8857.

Q. Why would a request for separate liability be denied?

A. Even if you meet the requirements listed above, a request for separate liability will not be granted in the following situations:

- The IRS proves that you and your spouse transferred assets for the main purpose of avoiding payment of tax.
- The IRS proves that at the time you signed your joint return, you had actual knowledge that any items giving rise to the deficiency and allocable to your spouse were incorrect.

Q. If a husband and wife are still married but separated for 12 month, prior to filing a claim for relief due to an involuntary reason such as incarceration or military duty, can separation of liability relief be granted?

A. Separation of liability applies to taxpayers no longer married, separated, or not living together for a period of 12 or more months preceding the filing of a claim. A claim can be filed if any of the three statutory requirements are met.

Q. What are the rules for Equitable Relief?

A. Equitable relief is only available if you meet all of the following conditions:

- You do not qualify for innocent spouse relief or the separation of liability election.
- The IRS determines that it is unfair to hold you liable for the understatement of tax taking into account all the facts and circumstances.
- Note: unlike innocent spouse relief or separation of liability, if you qualify for equitable relief, you can get relief from an understatement of tax or an underpayment of tax. (An underpayment of tax is an amount properly shown on the return, but not paid.)

Q. What Factors are considered in determining whether or not to grant equitable relief?

A. The following factors will be considered, but the list is not all-inclusive:

- Current marital status
- Abuse experienced during the marriage
- Reasonable belief, at the time you signed the return, that the tax was going to be paid
- Current financial hardship
- Underpayment or understatement attributable to the non requesting spouse
- Lack of significant benefit received by the requesting spouse

Q. How do state community property laws affect my ability to qualify for relief?

A. Community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Generally, community property laws require you to allocate community income and expenses equally between both spouses. However, community property laws are not taken into account in determining whether an item belongs to you or your spouse (or former spouse) for purposes of requesting any relief from liability.

Q. How do I request relief?

A. File Form 8857, *Request for Innocent Spouse Relief*, to ask the IRS for relief. You need not file multiple forms. One form can cover multiple years.

Q. Should I include a letter when filing Form 8857?

A. Yes, we request that you attach a statement to the Form 8857, providing additional information you wish to be considered.

Q. If I am denied innocent spouse relief, must I reapply if I believe I might qualify under one of the other two provisions?

A. No. The IRS automatically will consider whether any of the other provisions would apply.

Q. I applied for innocent spouse relief before the law changed (July 22, 1998). Do I need to reapply?

A. No. The Service will consider your request under the new law as long as the liability was unpaid as of July 22, 1998.

Q. Will the IRS deny me relief if I do not provide them with the information they request?

A. IRS will base their decision upon all the information available to them. If enough information is not available, it could adversely affect a request for relief.

Q. I filed a Form 656, *Offer in Compromise*, under doubt as to liability. The IRS accepted the Offer in Compromise. Can I still apply for innocent spouse relief?

A. No. We cannot consider your claim for any year in which an Offer in Compromise was accepted. Acceptance of an Offer in Compromise conclusively closes the tax year(s) compromised from any re-determination of the tax liability.

Q. I signed a closing Agreement, can I still apply for innocent spouse relief?

A. It depends on the type of closing agreement you signed.

- If you signed Form 866, *Agreement as to Final Determination of the Tax Liability*, the tax year is closed with finality and you cannot apply for innocent spouse relief.
 - If you signed Form 906, *Closing Agreement on Final Determination Covering Specific Matters*, only those matters covered in the closing agreement are conclusively closed. Innocent spouse relief may be requested for matters not covered in the closing agreement.
-

Q. When should I file Form 8857?

A. Follow the instructions on Form 8857.

Q. I am currently undergoing an examination of my return. How do I request innocent spouse relief?

A. File Form 8857 with the employee assigned to examine your return.

Q. What is the IRS has levied my account for the tax liability and I decide to request relief?

A. All collection activity is suspended, regarding the requesting spouse, from the date the request is received by the Service until a final determination is made.

Q. What constitutes a collection activity for purposes of starting the two-year statute of limitations the cover the filing of Form 8857?

A. A collection activity starts when the IRS makes an actual levy or seizure, or files a judicial suit or claim that puts the requesting spouse on notice the IRS intends to collect the joint tax liability from specific property belonging to that spouse.

Q. I filed a valid joint return with my spouse and have an installment agreement to pay the taxes. Can I still apply for relief?

A. The innocent spouse rules may apply in your situation. However, regarding the installment agreement, there are some important considerations:

- If you do not continue to make payments while we consider your request for relief, your installment agreement will default and full payment will be due immediately if your request for relief is denied.
- If you are granted relief under IRC 6015(b), you will be entitled to a refund of payments made while we considered your request.
- If you are granted relief under IRC 6015(c), you will not be entitled to a refund of any payments made.
- If you are granted relief under 6015(f), you will be refunded any payments made from the date of your request for relief.

Q. What is injured spouse relief?

A. Injured spouse relief is different from innocent spouse relief. When a joint return is filed and the refund is used to pay one spouse's past-due child and/or spousal support, a past-due federal debt, or past-due state income tax, the other spouse may be considered an injured spouse. The injured spouse can claim his/her share of the refund using Form 8379, *Injured Spouse Claim and Allocation*. To be considered an injured spouse, you must have:

- filed a joint return;
- received income (such as wages, interest, etc.);
- made tax payments (such as withholding or estimated tax payments);
- reported the income and tax payments on the joint return; and
- an overpayment, all or part of which was applied to the past-due amount of the other spouse.

Q. How can I get more information about innocent spouse relief?

A. Call the IRS Tax Forms line at 1-800-829-3676 and request Form 8857 and Publication 971, *Innocent Spouse Relief* (and other relief for joint filers).

Q. My spouse forged my signature to a joint return. Am I eligible for innocent spouse relief? Should I file Form 8857?

A. You are eligible for relief, but relief does not fall under the innocent spouse rules. If you can establish your signature was forged, and there was not tacit (implied) consent, the return is invalid with respect to you.

Q. What is the meaning of "undue Hardship" for purposes of equitable relief of an underpayment of tax liability shown on a tax return?

A. "Undue hardship" means significant hardship, i.e., more than an inconvenience to the taxpayer. It means the taxpayer will incur substantial personal or financial loss if required to pay the tax liability.

Q. Will I receive a refund of all amounts I paid, if relief is granted?

- A. It depends upon the provision under which relief is granted.
- If relief is granted under section 6013(e), refunds are allowed for amounts paid for the period beginning two years prior to the date the claim was filed and ending July 21, 1998.
 - If relief is granted under section 6015(b), refunds are allowable for amounts paid on or after July 22, 1998.
 - If relief is granted under section 6015(c), no refunds are allowable.
 - If relief is granted under section 6015(f), refunds are allowable for amounts paid between July 22, 1998 and April 15, 1999. Refunds are also allowable for amounts paid after the later of the date the claim was filed or July 22, 1998 pursuant to an installment agreement, provided the installment agreement is not in default.
-

Q. Will I be granted innocent relief with respect to unreported income if I feel it is my accountant's fault that the income was not reported on the return?

A. Innocent spouse relief is in no way meant to transfer the claim to an accountant. If the income was yours (rather than your spouse's), or was your spouse's but you knew about it, you will probably not be relieved of liability.

Q. If an understatement is the result of signing an examination report that lists omissions of income, does this indicate there was knowledge of items giving rise to the deficiency?

A. No, innocent spouse provisions clearly state the knowledge has to do with what was known at the time the return was signed.

**2001
TAX
INFORMATION
SERIES**

**ADOPTION TAXPAYER
IDENTIFICATION
NUMBERS**

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**LEGAL ASSISTANCE TELEPHONE
NUMBER**

OFFICE OF THE STAFF JUDGE ADVOCATE

Adoption Taxpayer Identification Numbers (ATINs)

Since January 1998, Philadelphia IRS Service Center (PSC) has been the sole processing site for Adoption Taxpayer Identification Number (ATIN) applications, assigning more than 2,000 ATINs during the first six months of their program. Qualifying applicants for ATINs are taxpayers who are in the process of adopting a child and who meet the criteria for claiming dependent status for the adoptive child but are unable to apply for a social security number (SSN) for the child pending final adoption. (Note: ATINs are issued for domestic adoptions only. Taxpayers involved in adopting a foreign child must apply for an ITIN for the child.)

ATINs are temporary numbers issued by IRS and are valid only for a two-year time period or until the applicant receives an SSN for the adoptive child. Many adopting parents often have custody of the child for a period of time pending the adoption and provide sufficient financial support during the year to claim the dependency exemption or child care credit on their returns; however, because of privacy issues, they do not have access to the child's existing SSN. Additionally, because the Social Security Administration (SSA) will only issue an SSN when the adoption is final, the parents are unable to provide a SSN when filing the return. (Note: Earned Income Tax Credit (EITC) is not allowed without a valid SSN issued by SSA; therefore EITC cannot be claimed while an ATIN is used on the return. After adoption is final and the taxpayer has obtained a valid SSN for the adoptive child, the parents may file an amended return to claim EITC during the period of pending adoption, provided all other EITC criteria are met.)

Form W-7A is used by taxpayers to apply for ATINs. As with ITINs, applicants will be required to provide supporting documentation with the application. Applicants may file Form W-7A at all IRS district offices and posts of duty where field personnel will verify the information and "pre-screen" the Form W-7A for accuracy and completeness.

Applicants may also mail the Form W-7A and supporting documentation to the PSC ITIN Unit. Information about tax benefits for adoption is available in Publication 968.

Philadelphia Service Center
ITIN Unit DP 426
P.O. Box 447
Bensalem, PA 19020

The ITIN Unit Customer Service phone number is (215) 516-ITIN (516-4846). The ITIN Unit fax number is (215) 516-3270. (Note: Processing for Forms W-7A and issuance of the assigned ATINs may take 4- to -6 weeks from receipt. Applicants should allow for that time period in making their applications and before inquiring about the status of their applications.)

**2001
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**INDIVIDUAL TAXPAYER
IDENTIFICATION
NUMBERS**

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**LEGAL ASSISTANCE TELEPHONE
NUMBER**

OFFICE OF THE STAFF JUDGE ADVOCATE

Individual Taxpayer Identification Numbers (ITINs)

Since the inception of the ITIN program in July 1996, Philadelphia Service Center (PSC) has issued more than 2 million ITINs to domestic and international tax filers who cannot obtain and do not qualify for a social security number.

ITINs are used for tax purposes only and do not supplant social security numbers. ITIN recipients are not eligible for the Earned Income Tax Credit (EITC) nor is an ITIN a valid ID number for work purposes. ITINs are permanent tax identification numbers and replace the former temporary IRSNs; consequently, IRS no longer accepts IRSNs or entries such as "applied for," "NRA," or "SSA205C" on tax documents and returns. As the ITIN must be applied for and assigned prior to tax form submission, "ITIN applied for" is not considered a valid entry either.

Those taxpayers eligible for ITINs include resident and non-resident aliens who are:

- required to file a U.S. tax return;
- claimed as a dependent of a U.S. person on a tax return;
- the spouse of a U.S. person who files a joint return;
- claimed as a spousal exemption on a U.S. tax return;
- filing a U.S. tax return solely for a refund claim;
- non-resident filing a U.S. tax return to claim a treaty benefit.

Those not eligible for ITINs are U. S. citizens and U.S. resident aliens who are eligible to receive social security numbers.

Applications for ITINs are made by filing Form W-7 with the supporting documentation described below. A revised version of the Form W-7, available since February 1998, reflects taxpayer feedback and is easier to understand and complete. A Spanish language version, Form W-7S, became available April 1998.

Forms W-7 may be submitted through several methods:

Individuals can present the completed Form W-7 and supporting documentation at any IRS walk-in office in the U.S. and abroad. An IRS reviewer will examine the material and return the documentation to the applicant. The Form W-7 is then certified by the reviewing office and forwarded to PSC for processing. An ITIN notice containing the number is generated during processing and is mailed directly to the applicant.

Applicants may also mail their completed Forms W-7 directly to PSC with the required documentation (see documentation definitions and mailing address below). These applicants also receive their ITINs directly from PSC via the mail.

Applicants may use the services of an Acceptance Agent who is authorized to certify Forms W-7 for IRS and review applicants' documentation. Acceptance Agents are tax practitioners and other qualifying agents such as educational institutions and government agencies who file the certified Forms W-7 on behalf of the applicants, receive the assigned ITINs from PSC and notify their clients of the assigned ITIN.

Acceptable documentation is defined as documentation that proves both identity and foreign status. Where a single document satisfies both requirements (such as a passport), one proof will suffice; otherwise two types of documentation are required. Types of acceptable documentation include passports, visas, national identity cards and driver's licenses.

Original documentation received by the PSC ITIN Unit is reviewed for acceptance or rejection within 14 days of receipt and returned to the applicant through the U.S. Postal Service (documents returned to foreign addresses are sent by registered mail). In lieu of original documents, applicants may also submit quality copies of documents which have either been certified by the issuing agency or notarized by a U.S. notary. (Note: If the documentation is in a foreign language, a certified translation must accompany it.)

Applications and/or supporting documentation that are rejected will be returned to the applicant with an explanation for the rejection and detailing what information is needed.

Additional information about ITINs can be obtained from Publication 1915, "Understanding Your Individual Taxpayer Identification Number."

Forms W-7 and documentation can be mailed to:

Philadelphia Service Center
ITIN Unit DP 426
P.O. Box 447
Bensalem, PA 19020

The ITIN Unit Customer Service phone number is (215) 516-ITIN (516-4846). The ITIN Unit fax number is (215) 516-3270.

(Note: Processing for Forms W-7 and issuance of the assigned ITINs may take 4- to -6 weeks from receipt. Applicants should allow for that time period in making their applications and before inquiring about the status of their applications.)

**2001
TAX
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SERIES**

**PUERTO RICO
TAX INFORMATION**

This pamphlet provides information concerning your federal income taxes. If you have legal questions concerning your taxes, and your unit tax advisor is unable to answer them, call the number below for an appointment to see a lawyer.

**LEGAL ASSISTANCE TELEPHONE
NUMBER**

OFFICE OF THE STAFF JUDGE ADVOCATE

Legal Residence (DOMICILE) in Puerto Rico:

Section 733a of the United States Code, Title 48, provides that “All citizens of the United States who reside or who shall after March 4, 1927, reside in the island for one year shall be citizens of Puerto Rico.” Despite this seemingly clear language, if a person claims legal residency some place else, he will be considered non-legal resident of Puerto Rico despite living in Puerto Rico for over a year. Persons who do not claim legal residency some place else, will be considered domiciled in Puerto Rico after residing in the Island for a year. If the person intends to remain here permanently, he does not need to wait one year before establishing legal residence. In practice, no one is forced to be a Puerto Rico resident, or to vote here. A person who does not want to be considered a domicile of Puerto Rico will retain his original legal residence/domicile as long as his acts do not demonstrate his intent to change his legal residence.

Residents under the Puerto Rico Tax Code:

The Puerto Rico Tax Code defines "Resident Individual" as a person who is domiciled in Puerto Rico. The tax code presumes that an individual is a resident of Puerto Rico if he has been present in Puerto Rico for a period of one hundred and eighty (180) days during the calendar year. There is no regulation under the code related to the factors to be considered to determine if a taxpayer is a resident or non-resident of Puerto Rico. Therefore, apply the principles stated above on how to establish, and how to avoid establishing, a new legal residency. See the fact sheet, Puerto Rico Income Tax Information for Non-residents.

Puerto Rico Income Tax Information (Residents)

This fact sheet outlines the requirements for filing income tax returns for **legal residents of Puerto Rico** (legal residence as determined by evidence of domicile, e.g., the last state in which one voted, place of entry on active duty [home of record], state expressed as one's domicile in a will) or for those who recently changed their legal residence from Puerto Rico to one of the states of the United States for the tax year. See the Legal Residence and Voting Rights fact sheet.

Whether or not you are required to file a Puerto Rico tax return in addition to a federal return is based on:

Whether you were a legal resident of Puerto Rico on 31 December¹ or;

Whether you changed your legal residence from Puerto Rico to one of the states of the United States during the tax year (before 31 December).

Individuals who claim Puerto Rico as their legal residence may take a credit on the Puerto Rico or federal income tax return for the taxes paid to the United States or to Puerto Rico. The procedure for taking the credit may change based on where you are stationed:

MILITARY WHO ARE LEGAL RESIDENTS OF PUERTO RICO:

AND RENDERED SERVICE IN:	MAY CREDIT WITH:	AND MUST FILE TAX RETURN:
a. Puerto Rico	United States	Puerto Rico and Federal
b. Overseas	United States	Puerto Rico and Federal
c. United States	Puerto Rico	Puerto Rico and Federal

For a and b above, follow this procedure to take the credit: (1) Complete the Puerto Rico return (Form 482PR); (2) Complete the federal return (Form 1040); (3) Complete Form 1116 (U.S.) to take the foreign tax credit; (4) Mail the Puerto Rico return to the Department of the Treasury in Puerto Rico; and (5) Mail the federal return (Form 1040) and Form 1116 to the servicing IRS office.

For c above, follow this procedure to take the credit: (1) Complete the Federal return (Form 1040); (2) Complete the Puerto Rico return (Form 482PR) and the Puerto Rico credit worksheet to take the credit on Form 482PR; (3) Mail the Puerto Rico return AND the Puerto Rico credit worksheet to the Department of the Treasury in Puerto Rico; and (4) Mail the federal return (Form 1040) to the servicing IRS office.

If you were a legal resident of Puerto Rico during part of the year (i.e., you changed your legal residence from Puerto Rico to one of the states of the United States during 1998) and you were a legal resident of that state as of 31 December, then follow this procedure to claim the credit: (1) Complete the Puerto Rico return (Form 482PR) for the period you were a legal resident of Puerto Rico (i.e., from 1 January 1998 until the date you changed your legal residence); (2) If you were living or stationed in a state of the United States during the period of legal residency for Puerto Rico, complete the Puerto Rico worksheet to take the credit on Form 482PR. If you were living or stationed in Puerto Rico or outside the states of the United States, complete Form 1116 (U.S.) to take the credit on your federal return; (3) Complete the federal return (Form 1040); (4) Complete the state return of your new legal residence; (5) Mail the Puerto Rico return, a copy of DD Form 2058 (Change of Residence Form), and a certified copy of your federal return in order to prove the change of legal residence to the Department of the Treasury in Puerto Rico; and (6) Mail the federal return (Form 1040) to the servicing IRS office.

Part-year residents and nonresidents of Puerto Rico may be entitled to a refund for taxes paid to Puerto Rico.

Puerto Rico requires proof that you have actually changed your residence to a state of the United States. In addition to submitting a copy of DD Form 2058 (Change of Residence Form), you should submit a copy of your federal income tax return. When applicable, you should submit a copy of your first leave and earnings statement (LES) for the tax year showing Puerto Rico as the place of legal residence and a copy of the first LES showing a state of the United States as the place of legal residence. If you did not have Puerto Rico as your legal residence during any part of the year, but for some reason income tax was withheld for Puerto Rico, follow this procedure to claim a refund of the taxes withheld: (1) Complete Form SC 2698 (Claim for Refund of Income Tax Erroneously or Illegally Collected); (2) Mail the Form SC 2698 together with a copy of the DD Form 2058 to the Department of the Treasury in Puerto Rico. The DD Form 2058 should indicate that your residence is a state of the United States.

Important factors to keep in mind by Puerto Rico residents when preparing a Puerto Rico return:

- a. Puerto Rico taxable income includes all income from whatever source, wherever located including passive income.
- b. Puerto Rico does not tax unemployment compensation or social security benefits.
- c. The basic pay and all allowances are included as income for Puerto Rico, except when exempted by federal law. The COLA can be excluded from gross income, subject to certain requirements.
- d. The first \$2,000 of interest earned on an account located **in** Puerto Rico are exempt.
- e. The alternative minimum tax paid in the federal tax return can be accepted as a credit against the tax liability determined in Puerto Rico, if there are U.S. sources income.
- f. Moving expenses for transfer from one place of work to another by request of your employer can be deducted from your gross income. If the moving is for the convenience of the employee, any concession received will be included in the gross income and the expenses incurred are not deductible.
- g. The taxpayer may elect to claim the total of itemized deductions if they are greater than the standard deduction. The **long form** return and the **Schedule A Individual** must be completed to claim the itemized deductions.
- h. Additional Deductions: The additional deductions can be claimed in the long and short form.
- i. Who Must File: Every individual resident of Puerto Rico who is:
 - (1) Single (or married not living with spouse) and who has a gross income over \$3,300 during the taxable year; or
 - (2) Married living with spouse and who has individually or jointly, a gross income over \$6,000 during the taxable year.
- j. When You Must File: You must file your return on or before April 15. If you cannot file your Puerto Rico return by the 15 April deadline, you must fill out Form SC 2650 (automatic 30-day extension) and include one-half of any tax liability due. Near the end of the extension, you may file Form 2644.1 to obtain an additional extension.
- k. Where You Must File: The return can be filed at the following address:
 - (1) Returns with refund: Department of the Treasury, P.O. Box 50072, San Juan, PR 00902-6272
 - (2) Returns with Payments or Others: Department of the Treasury, P.O. Box 9022501, San Juan, PR 00902-2501
- l. When you file the Puerto Rico Tax Return, you must provide the following information: Date of birth (for husband and wife); social security number for husband and wife and all dependents; the wife's maiden name if she is from Puerto Rico; and each parent's last name.

Puerto Rico Points of Contact:

Taxpayer Services Office: (Office 204), Bureau of Income Tax, Box 2501, San Juan, Puerto Rico 00902.
Telephone: 721-2020, Ext. 3611

Federal Employees Assistance Office: (Office 401) Tel. (787) 721-2020, Ext. 3901/3902.

Technical Advice: 1-800-981-9236 or (787) 721-2020, Ext. 3611

TeleHacienda: 1-800-981-0675 or (787) 721-0510 24 hours

Internet: <http://www.hacienda.gov.pr>

E-mail: hacienda@www.hacienda.gov.pr

Puerto Rico Income Tax Information (Non-Residents)

1. Non-Residents Defined For purposes of this information sheet, a non-resident of Puerto Rico is defined as follows:

(a) Service Member A non-resident service member is an active duty member of the Armed Forces of the United States who is assigned to a permanent duty station located in Puerto Rico, and whose permanent home of record or legal residence is located outside of Puerto Rico.

(b) DOD Civilian A non-resident DOD civilian is a Department of Defense civilian employee who is assigned to a permanent duty station in Puerto Rico and whose permanent home of record or legal residence is located outside Puerto Rico.

(c) Dependent A dependent of a service member or DOD civilian is the non-active duty military spouse, minor child or other person accompanying the service member or DOD civilian during his tour of duty in Puerto Rico.

2. Income Tax Treatment of Service Members The military pay and allowances of a non-resident service member are not taxable by Puerto Rico. The service member need only file a federal tax return, annually. On the other hand, any non-military service related income earned by the service member (or a dependent) from Puerto Rican sources, is taxable by Puerto Rico. In this event, the service member must file both a federal and a Puerto Rico tax return, annually.

3. Income Tax Treatment of DOD Civilians The federal salary and other allowances (with some exceptions, e.g., COLA) of a non-resident DOD civilian, as well as outside income earned by him (or a dependent) from Puerto Rican sources, are taxable by Puerto Rico. A DOD civilian must file both a federal and a Puerto Rico tax return, annually.

4. Foreign Tax Credit Service members who must pay Puerto Rico income tax on non-military service related income from Puerto Rican sources and DOD civilians who pay Puerto Rico income tax on their federal salary, allowances and other outside income derived from Puerto Rican sources, as a general rule, may take a dollar for dollar credit against federal taxes owed for income taxes paid to Puerto Rico, pursuant to the foreign tax credit provisions of the Federal Internal Revenue Code.

5. Taxable Gross Income Defined Taxable gross income under the Puerto Rico Internal Revenue Code of 1994, as amended (Tax Code), includes gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, as well as from professions, vocations, trades, businesses, commercial transactions and transactions involving the sale, purchase or exchange of personal or real property. Also included is income from interest, rent, dividends, partnership profits, securities, transactions involving for profit businesses and from any other sources whatsoever.

6. Individual Resident Status The Tax Code defines a *resident* as an individual whose domicile is Puerto Rico. There is a rebuttable presumption that an individual is a domiciliary of Puerto Rico if he or she has resided in Puerto Rico continuously for 180-days. The individual may rebut this presumption by demonstrating, for example, that he has not voted in any Puerto Rican election, maintains a stateside driver's license, has a current transportation agreement with the federal government to return to a home of record outside Puerto Rico or claims a permanent home of record or legal residence outside Puerto Rico in his official personnel files.

7. Individual Tax Rates Individuals subject to Puerto Rico income tax, without regard to whether they are residents or non-residents of Puerto Rico, and who are United States citizens, are taxed the same. Individual Puerto Rico income tax rates for 1997 range from a minimum of eight percent (8%), to a maximum of thirty-three percent (33%).

8. Cost of Living Allowance Beginning 1 January 1996, the cost of living allowance (COLA) received by certain DOD civilians assigned to duty stations in Puerto Rico, is not taxable income for Puerto Rico income tax purposes, subject to taxpayers' submitting the following information with his tax return:

- (a) COLA dollar amount received during the applicable tax year;
- (b) Proof (or certification) of filing of Puerto Rico income tax returns during the preceding four tax years (if the taxpayer had an obligation to file returns during such period); and
- (c) Proof (or certification) of payment of all past due income tax or a current approved installment payment plan.

9. Sale of Property by Non-Resident Persons Any person who purchases from a non-resident of Puerto Rico, real property or shares of stock (if the profit derived from the transaction constitutes income from sources within Puerto Rico), must deduct and withhold from the purchase price of the property, an amount equal to twenty-five percent (25%) of the purchase price, except that if the seller is a citizen of the United States, the amount withheld is twenty percent (20%). To obtain a waiver of this withholding requirement, the seller must submit a waiver request to the Puerto Rico Treasury Department, together with supporting documentation showing the seller's current Puerto Rico income tax liability has been satisfied.

10. Tax Treatment of Retirement Income Retirement income received by non-residents, for work or services performed outside Puerto Rico, is not taxable by Puerto Rico. Retirement income received by residents, for work or services performed inside or outside Puerto Rico, and by non-residents for work or services performed inside Puerto Rico, is taxable by Puerto Rico. Certain exemptions from gross income and tax credits for retirement income tax paid to the Federal Government may apply.

11. Exemption from Puerto Rico Excise Tax on Household Goods and POV's

Service members and DOD civilians who are assigned official duty stations in Puerto Rico pursuant to permanent change of station travel orders, are exempt from Puerto Rico excise taxes on household goods and one (1) personally-owned vehicle (POV) shipped at government expense. Note that recreational watercraft are not authorized to be shipped at government expense and, therefore, if shipped to Puerto Rico at the personal expense of the service member or DOD civilian, they will be subject to the excise tax, currently six point six percent (6.6%) of appraised value. The excise tax on non-exempt motor vehicles may be from thirteen (13%) to forty (40%) percent of the vehicle's taxable price in Puerto Rico. The excise tax exemption on household goods and POV's terminates when the exempted articles are sold or transferred.

12. Useful Tips For Filing Puerto Rico Income Tax Returns:

- (a) As a general rule, the taxpayer must report all income from whatever source, including passive income.
- (b) There is no requirement to report non-taxable unemployment compensation or social security benefits.
- (c) The first \$2,000 in interest earned on an account in a financial institution located in Puerto Rico is exempt.
- (d) The federal alternative minimum tax may be accepted as a credit against a taxpayer's Puerto Rico income tax liability, if the income on which the minimum tax is based, is derived from sources outside Puerto Rico.

(e) Moving expenses incurred by an employee in connection with an employer-requested transfer from one workplace to another, are deductible from gross income of the employee. Moving expenses incurred by an employee for moves undertaken for the employee's convenience are not deductible.

(f) Standard Deductions:

Filing Status	Long Form	Short Form
Married (filing jointly with spouse)	\$3000	\$6000
Married (not living with spouse)	\$2000	\$3300
Married (filing separately)	\$1500	\$0.00
Head of Household	\$2600	\$5600
Single	\$2000	\$3300

(g) The taxpayer may claim the total of itemized deductions, provided they are greater than the standard deduction. To claim the itemized deduction amount, the taxpayer must submit a "long form" tax return, with attached "Schedule A".

(h) Additional deductions can be claimed in the long and short form.

(i) Every U. S. citizen, non-legal resident DOD civilian who is:

(1) Single (or married and not living with spouse) and who has a gross income over \$1,300 during the taxable year; or

(2) Married living with spouse and has a joint gross income over \$3,000 during the taxable year, must file a Puerto Rico income tax return (unless the taxes on such income have been paid in full at the source).

(j) Filing Deadline Tax returns are due on or before April 15. An automatic 30-day extension may be obtained by filing Form SC 2650 along with half of the estimated tax liability due. For an additional extension, use Form 2644.1.

(k) Filing Locations Tax returns should be filed as follows:

(1) Returns Seeking Refund Department of the Treasury, P.O. Box 50072, San Juan, PR 00902-6272

(2) Returns Making Payments/Others Department of the Treasury, P.O. Box 9022501, San Juan, PR 00902-2501

(m) Required Information The tax return must include the following information: husband's, wife's and dependent's names, dates of birth, and social security numbers, wife's maiden name (if Puerto Rican) and taxpayers' parents last names.

(n) Limitation on Deductions: A non-resident taxpayer may not claim as a deduction for Puerto Rico income tax purposes, any deduction pertaining to income producing property or an asset located outside Puerto Rico, unless the income from the asset giving rise to the deduction is also reported as part of the taxpayer's gross income. For example, income earned from sources outside Puerto Rico (e.g., rental income from property in CONUS) is not taxable by Puerto Rico, therefore a DOD civilian cannot claim a deduction for interest expense on a rent house in CONUS unless the rent income is included in the amount he reports as gross income on his Puerto Rico income tax return.

13. Points of Contact for Puerto Rico Income Tax Information:

(a) Taxpayer Services Office: (Office 204), Bureau of Income Tax, Box 2501, San Juan, PR 00902.
Telephone: 721-2020, Ext. 3611

(b) Federal Employees Assistance Office: (Office 401) Tel. (787) 721-2020, Ext. 3901/3902.

(c) Technical Advice: 1-800-981-9236 or (787) 721-2020, Ext. 3611

(d) TeleHacienda: 1-800-981-0675 or (787) 721-0510 24 hours

(e) Internet: <http://www.hacienda.gov.pr>

(f) E-mail: hacienda@www.hacienda.gov.pr

14. Disclaimer: This information sheet contains *basic* Puerto Rico income tax information. While it is believed the information is accurate, it is not and the reader should not consider the information to be a substitute for the advice of an attorney, accountant or other professional experienced in Puerto Rico income tax law, practice and procedure.

EXCISE TAX OF PUERTO RICO

Attached to this legal guide is the letter detailing the taxation policy of Puerto Rico. It states that personal property introduced into Puerto Rico by active duty military members is exempt from Puerto Rico excise taxes, provided that Puerto Rico is not the domicile of the military members.

Further, DOD civilians who are officially transferred to render services in Puerto Rico are entitled to introduce the following items exempted from the payment of excise tax:

- articles of personal use belonging to the person transferred and the other members office family that accompany him,
- household appliances and
- one motor vehicle

In addition, DOD Civilians' items must be introduced as a consequence of, and it is made at the time of the order to transfer. For purposes of the Puerto Rican Internal Revenue Code of 1994, as amended, and its regulations, motorcycles, boats, personal watercrafts and mobile homes are not deemed to be articles of personal use or household goods and are subject to Puerto Rican excise taxes.

The exemption is extended to the spouse and dependents of the service member who live under service member's immediate custody. The exemption allowed ceases as soon as the person transferred, sells, or cedes the articles this introduced. The new acquirer is bound to pay, at the time of the sale or transfer, the corresponding excise taxes computed on the basis of the market value of such articles. Service members moving to Puerto Rico for retirement or separation or who are residents of Puerto Rico and move their families to Puerto Rico when they are assigned to another are where dependents are authorized are subject to the excise tax. The excise tax on personal property is 6.6% of the appraised valued of the taxable items.

Puerto Rico exempts only one vehicle per AD service member or DOD civilian. Excise tax must be paid on a second or third car based on the "Blue Book" retail value: Taxable value = Blue Book Retail Value X 1.30 = \$X and apply the following table.

Automobiles: Taurus, Accord, Corolla, Grand Prix or similar:

Up to \$5,844	\$750.00 minimum tax
From \$5,844 to \$10,130	\$750 plus 13% of the excess of \$5,844
From \$10,130 to \$20,260	\$1,307 plus 25% of the excess of \$10,130
From \$20,260 to \$42,546	\$3,840 plus 40% of the excess of \$20,260
More than \$42,546	30% of the suggested retail price

Multiple use and Sport Utility Vehicles: Jeep, Explorer, Minivans less than 14 passengers:

Up to \$20,000	13% of the suggested retail price
More than \$20,000	\$2,600 plus 20% of the excess of \$20,000

Motorcycles, Boats and Jetskies are taxed as personal property, at 6.6% of the appraised valued by the PR Treasury Department or a recent bill of sale. The PR Treasury Department also uses Blue Book for motorcycle and boats as reference.

To obtain PR excise tax exemption, the service member or DOD civilian must present PR tax authorities the following documents:

- Copy of his/her PCS orders
- The bill of lading
- The corresponding Title and registration documents
- If the vehicle has an outstanding car loan, need letter from the bank authorizing the shipment of the vehicle into PR.
- DD 788
- Private vehicle shipping/inspection and appraisal document.
- ID card.
- ACAA sticker

All motor vehicles are required to have Puerto Rico Medical Liability Insurance, called ACAA at a cost of \$35.00 per year. The Puerto Rico Motor Vehicle Compulsory Liability Insurance (CLI) Law (“No-fault Insurance” in other states), requires that all motor vehicles transiting on the Puerto Rico public highways have a liability insurance coverage of not less than \$3,000.00 at a cost of \$99.00 per year. You must comply with the CLI even if your vehicle is not registered in Puerto Rico and retains out-of-state license plates. See the Compulsory Liability Insurance Fact Sheet for more information.

No vehicle is released to the owner until the ACAA fee is paid and the CLI is paid of the owner shows proof of insurance coverage.

Mopeds or motorcycles shipped, as HHG must be packed separately from other HHG since the PR Tax authority must clear them. Excise taxes will have to be paid when vehicles arrive in PR more than 90 days after member's arrival. An extension of up to six months may be granted in unusual cases.

It is highly recommended that prior to ship a taxable POV, double check with the PR Tax Bureau on the tax due. The PR Tax Bureau provides tax information by calling (787) 774 1463/1474 or (787) 783-3010 for information on boats.

Taxes in Puerto Rico

	POV (CONUS)	POV (OCONUS)	PROPERTY	Motorcycle (CONUS)	Motorcycle (OCONUS)	BOAT (CONUS)	BOAT (OCONUS)
SOLDIERS	NO REQUIREMENT TO REGISTER	REGISTER CLI-\$99 TOTAL=\$150-200	NO TAX ON ORDER	NO TAX	TAX 6.6%		TAX 6.6 %
	NO TAX	NO TAX	TAX IF BOUGHT IN PUERTO RICO			SSCRA	
	ACAA-\$35	ACAA-\$35				NO TAX	

CIVILIAN	NO REQUIREMENT TO REGISTER	REGISTER (1) CLI-\$99 TOTAL=\$150-200	NO TAX ON ORDER	TAX	TAX	TAX	TAX
	NO TAX	NO TAX	TAX IF BOUGHT IN PUERTO RICO				
	ACAA-\$35	ACAA-\$35					

(1) PR authorizes importation of one car and personal property without subject to excise taxes, but that is strictly up to the Commonwealth

FACTS:

1 . SSCRA prevents PR from imposing taxes and registration requirements on soldiers' POV's and property IF the POV was registered and has plates in the HOR or tax state in CONUS and the property was brought into PR pursuant to PCS orders.

2. NO SSCRA protection for civilians: civilians could be forced to pay all taxes and registration fees. As it is, civilians apparently can bring in one car w/o paying any taxes or having to register it in PR if it has US tags; otherwise all other property is subject to taxes, fees, etc., from the Commonwealth.

3 . However, if the POV or property brought into PR was purchased OCONUS and never paid tax or registered it (or registered it in Panama which won't be recognized in PR), not even SSCRA will protect a soldier and civilians aren't protected. Accordingly, the soldier has to get the car registered and taxes paid to the HOR or tax residence ASAP before shipping the car to Puerto Rico or else PR may assess the excise taxes on the POV.

BOTTOM LINE

All soldiers and civilians have to pay ACAA (\$35) for medical insurance and CLI (Compulsory Liability Insurance) in a minimum of \$3000.

A. This is regardless of whether car is registered in Puerto Rico or not.

B. CLI costs \$99 for personal cars and \$148 for commercial vehicles.

C. If POV is registered in Puerto Rico, will cost from \$150-200 and the \$99 CLI is included in the cost. Some insurance companies will reduce the premiums if you show that you already paid the first \$3000 in CLI. You also get a sticker that proves you paid the CLI.

D. But if the POV isn't registered in Puerto Rico, there isn't a separate sticker like for ACAA and you have to keep the proof you either paid for CLI from Joint Underwriters Association (JUA) in Puerto Rico or from an insurance company licensed to do business in Puerto Rico and put it in your POV if you're stopped by local police (or you can be hauled to court and the fine for not having CLI is \$500).

**2001
TAX
INFORMATION
SERIES**

**IRS URGES
AFRICAN-AMERICANS TO
BEWARE OF TAX REFUND
SCAMS**

This pamphlet provides information concerning your federal income taxes. If you have legal questions concerning your taxes, and your unit tax advisor is unable to answer them, call the number below for an appointment to see a lawyer.

**LEGAL ASSISTANCE TELEPHONE
NUMBER**

OFFICE OF THE STAFF JUDGE ADVOCATE

The Internal Revenue Service today cautioned African-Americans not to be misled by anyone offering to help them file for tax credits or refunds related to reparations for slavery. There is no such provision in the tax law. Those who pay to have reparations-related tax claims prepared are being deceived. IRS centers nationwide have received a growing number of such slavery reparations claims this year, repeating similar experiences in 1994 and 1996. "We regret that people may be circulating misleading information in the African-American community," said IRS Commissioner Charles O. Rossotti. "It's despicable that some are stealing from innocent people by charging fees to prepare what they know to be baseless claims." For example, the Florida Attorney General obtained an injunction late last month against a Miami-based promoter who charged victims \$100 to handle their "claims." This promoter even warned consumers not to contact the IRS on the pretext that the IRS did not want the general public to know about the tax credit. "Promoters do not want potential victims to learn the truth about this hoax," Rossotti said. The IRS has seen two principal reparations schemes. In one, the person claims a credit for "black investment taxes" or "reparations for African-Americans." In the other, the person attaches a form listing thousands of dollars in tax withholding that, in fact, never occurred. Because there is no law providing for such reparations, the IRS rejects these claims. Taxpayers who repeatedly file them after receiving a denial notice may be subject to a \$500 penalty for filing a frivolous tax return. Promoters of reparations tax schemes have been convicted and imprisoned, and the IRS continues to investigate new promoters for possible prosecution. People hearing about tax benefits that sound "too good to be true" should check them out with a trusted tax professional or the IRS before getting involved with claims that may not be legitimate. The IRS toll-free help line is 1-800-829-1040.

**2001
TAX
INFORMATION
SERIES**

**NAME & NUMBER USED
ON TAX RETURNS**

This pamphlet provides information concerning your federal income taxes. If you have legal questions concerning your taxes, and your unit tax advisor is unable to answer them, call the number below for an appointment to see a lawyer.

**LEGAL ASSISTANCE TELEPHONE
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OFFICE OF THE STAFF JUDGE ADVOCATE

The Internal Revenue Service is sending letters to 2.4 million taxpayers who filed a joint 1999 return on which the name and identification number for the second spouse listed did not match IRS records. The IRS advises these taxpayers to compare the name and number used on the return with the information on the identification card issued by the Social Security Administration (SSA) or the IRS. The mailout began last month and will continue until mid-November. Taxpayers must provide correct names and identification numbers in order to claim a personal exemption or the Earned Income Tax Credit. For several years, the IRS has been increasing its efforts to verify compliance with this law. In the past, the IRS has not accepted electronic returns with any name/number mismatch, whether for the taxpayer, the spouse, or a dependent. It has also reduced tax benefits claimed on paper returns when there was a name/number mismatch for the first spouse listed on a joint return or for any dependent. This coming year, the IRS will do the same for both spouses on a paper-filed joint return. People who change their surnames for any reason -- such as marriage -- should get updated identification cards, unless they intend to use the former name for legal purposes. Form SS-5, "Application for a Social Security Card," is available from the SSA Web site at www.ssa.gov, or by calling (toll-free) 1-800-772-1213.

**2001
TAX
INFORMATION
SERIES**

**TAXPAYER RIGHTS AREA
CREATED FOR IRS WEB
PAGE**

This pamphlet provides information concerning your federal income taxes. If you have legal questions concerning your taxes, and your unit tax advisor is unable to answer them, call the number below for an appointment to see a lawyer.

**LEGAL ASSISTANCE TELEPHONE
NUMBER**

OFFICE OF THE STAFF JUDGE ADVOCATE

The Internal Revenue Service has created a special new web section for taxpayers seeking information about their rights when dealing with the nation's tax agency. The new "Taxpayer Rights Corner" premiered this week at [www.irs.gov](http://www.irs.gov/ind_info/txpyr_rights/index.html) under the "Tax Info for You" section. The page can be accessed at http://www.irs.gov/ind_info/txpyr_rights/index.html.

The section brings a variety of issues involving taxpayer rights issues into one convenient place. Previously, much of the material was located in different parts of the IRS web site. "The IRS is making it easier for taxpayers to find information about their rights," said Bob Wenzel, IRS Deputy Commissioner. "This section is designed to be an easy, one-stop shop." The Taxpayer Rights Corner includes topics ranging from basic taxpayer information to detailed steps on how to get help from the IRS. Among the areas highlighted on the web page:

- _ "Know Your Rights" spells out basic taxpayer rights.
- _ The notice section gives quick links to understanding IRS notices.
- _ For examination and collection issues, the Taxpayer Rights Corner connects to publications detailing step-by-step IRS processes.
- _ If taxpayers have a disagreement with the IRS, information is available in the Appeal Rights section.
- _ Taxpayers with difficulty solving their problems through normal IRS channels can contact the Taxpayer Advocate Service.
- _ The site also has information on questions involving legal representation and confidentiality privileges.

The IRS worked with several groups while preparing the Taxpayer Rights Corners, including members of the IRS Advisory Council, the Citizen Advocacy Panel, the Community Tax Law Project and others in the business and tax professional community. This is a great service," said American University Tax Law Professor Janet Spragens, who assisted with the site. "It has tons of useful information for taxpayers." Inside the IRS, the Taxpayer Advocate Service and Appeals Division worked with Communications and Liaison Division and Multimedia Production on the project. "The Taxpayer Rights Corner provides valuable information for taxpayers interacting with the IRS," Wenzel said. "This web page reflects the agency's commitment to safeguarding taxpayer rights."
